# Audit Report

**District Inspector General for Audit**
**Rocky Mountain District**

# *Follow-up Nationwide Review*

# *Department of Housing and Urban Development's Loss Mitigation Program*

## *2002-DE-0001*
## *February 28, 2002*

Department of Housing and Urban Development
District Office of Inspector general For Audit
633 17th Street, 14th Floor
Denver, CO 80202-3607

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**District Inspector General for Audit**
**Rocky Mountain District**

*Report: 2002-DE-0001 Issued: February 28, 2002*

**TO**: **John C. Weicher, Assistant Secretary for Housing – Federal Housing Commissioner, H**

Robert C. Gwin

**FROM: Robert C. Gwin, District Inspector General for Audit, 8AGA**

**SUBJECT: Department of Housing and Urban Development's Loss Mitigation Program**

We have concluded a follow-up audit of the Department of Housing and Urban Development's Loss Mitigation Program. Our overall audit objective was to determine whether the Single Family Loss Mitigation Program is effectively and efficiently achieving HUD's goals for increased home retention and minimized costs to the insurance fund. The audit included reviews at six large and two midsize servicing mortgagees, the private contractor servicing partial claim notes, and the Office of Housing, Single Family Division.

Within 60 days please furnish to this office, 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.

Should you have any questions, please call Ernest Kite, Assistant District Inspector General for Audit, at (303) 672-5452.

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# Executive Summary

**We performed a nationwide follow-up audit of HUD's Single Family Loss Mitigation Program to evaluate whether the program is effectively and efficiently achieving HUD's goals for increased home retention and minimized costs to the insurance fund. We first audited this program in 1999. The follow-up audit was planned in the Office of Inspector General's fiscal year 2001 annual audit plan. Our audit work included reviews at six large and two midsize servicing mortgagees. We also reviewed the private contractor servicing partial claim notes and the Office of Housing, Single Family Division, which includes the National Servicing Center.**

**The Department has exceeded its goals to increase the usage of loss mitigation strategies, thereby reducing losses to the FHA insurance fund with foreclosure avoidance. Although HUD has expanded the usage of the loss mitigation on FHA-insured loans, additional work is needed to improve the administration of the program. We identified four issues that are keeping the loss mitigation program from reaching its full potential and achieving HUD's goals to help borrowers retain homeownership while mitigating the economic impact to the FHA insurance fund.**

**First, servicers are approving borrowers for loss mitigation when, based on the servicers' expertise and past experience with delinquent borrowers, the workout is unlikely to succeed. These actions are delaying the foreclosure process, increasing the cost of foreclosure, and subsidizing borrowers who don't pay their mortgage for extended periods of time. Further processing delays are caused by HUD requirements. Second, servicers are over relying on partial claims, the costliest of the three home retention loss mitigation strategies, because partial claims are quick and easy to process while other loss mitigation strategies are more complicated. Third, additional collection procedures are needed to collect borrowers' defaulted partial claim notes that are not paid during the sales or refinance transaction. Fourth, HUD needs to improve its monitoring and oversight of large servicers to ensure the servicers are consistently administering the loss mitigation program within HUD requirements.**

**To resolve these problems, the Department needs to enhance existing policies and procedures to improve the effectiveness and efficiency of the program to further achieve HUD's goals.**

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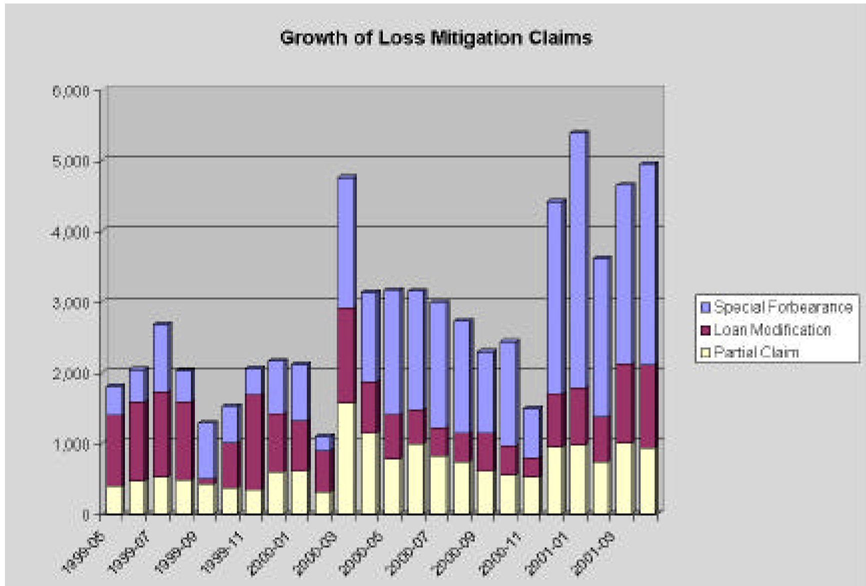
The Loss Mitigation Program has made considerable progress since our last review

HUD has made considerable strides improving the Loss Mitigation Program since the last time we looked at it. During the period covered by our review, the Department issued four mortgagee letters clarifying loss mitigation policies and providing procedural changes; designed and developed a comprehensive training program to promote and enhance the use of loss mitigation strategies; and targeted servicers, who have not adequately implemented the program, for quality control reviews to encourage them to use the loss mitigation program as prescribed by HUD.

During our audit period from May 1999 to April 2001, the program has significantly grown from about 2,000 claims per month to over 4,000, as the following chart shows:




Most of this growth is attributed to greater usage of special forbearances and partial claims. From fiscal year 1999 to 2001, special forbearance usage increased 396%, from 5,724 to 28,395 claims per year. Partial claims increased 169%, from 3,977 to 10,708 claims per year. Loan modifications claims are relatively at the same level increasing fewer than 2%, from 11,114 to 11,282 claims per year. During this same period, foreclosures decreased 20%, from 74,276 to 59,733 per year.

The Department is also using a workout ratio to measure program performance. The workout ratio is calculated as the total number of the five loss mitigation tools divided by the total number of the five loss mitigation tools plus total foreclosures. The fiscal year 2001 workout ratio, through August, increased 39% to 47% from the fiscal year 2000 rate of 34%. This increase is a result of increasing workouts and decreasing foreclosures.

The Department is still developing improvements to the program

The Department is also in the process of completing two other improvements to the program. Enhancements to HUD's Neighborhood Watch System will make available loss mitigation activity by particular servicers or regions to the industry and should be available sometime next year. Thus, Neighborhood

Watch will help the industry identify particular servicers whose portfolios have deficient loss mitigation exposure. Also, the Single Family Asset Management staff is developing a new tier ranking system to rate lenders performance, which may be ready to use during the first quarter of 2002. This new performance rating model will replace the model currently being used to measure loss mitigation performance, base increased incentives and target servicers for quality control reviews.

The Department has made considerable progress getting servicers to administer the loss mitigation program. We believe that the next priority for the Department should be to enhance existing policies and procedures to improve the effectiveness and efficiency of the program to further achieve HUD's goals. We discuss four findings in this report that illustrate conditions that are keeping the loss mitigation program from reaching its full potential.

Program effectiveness can be improved

First, HUD delegates servicers to use good business judgment to ensure that the selected loss mitigation workout options reasonably reflect the borrower's ability to pay. We found that servicers were performing due diligence when approving the borrowers for loss mitigation based on the information provided by the borrower. However, three of the large servicers were approving multiple loss mitigation tools, even when they knew the workouts would not succeed. Consequently, these actions are delaying the foreclosure process, increasing the cost of foreclosure, and subsidizing borrowers who do not pay their mortgage for extended periods of time. Servicers interpreted verbal instructions provided by HUD's National Servicing Center, to mean that virtually any interested borrower is permitted into the program. Servicers are reluctant to deny loss mitigation when it is prudent to do so because the servicer may have to indemnify the loan later if HUD disagrees with the decision.

Further delays are caused by HUD's requirements to wait 90 to 120 days before implementing loss mitigation tools, to wait 60 days before a broken special forbearance is considered a failure, and to wait at least 90 days to begin the foreclosure process after a loan is reinstated by a partial claim or loan modification. We identified multiple instances where borrowers are immediately going back into default after servicers fully reinstate their delinquency with a partial claim.

The costliest option to the insurance fund is being overused

Second, HUD requires that lenders use the hierarchy of loss mitigation option priority to help minimize losses to the insurance funds. The partial claim option, the costliest of the three home retention loss mitigation tools, is being overused. Out of the top twenty-five servicers with the highest percentage of loss mitigation claims, eleven used partial claims more often than loan modifications, three used them more than special forbearances, and four used them more often than both loan modifications and special forbearances. Thus, most large servicers relied more heavily on partial claims than they did on one of the other two home retention strategies.

We identified during our review instances where partial claims were granted for borrowers that would have qualified for one of the other two loss mitigation retention options. Servicers are relying on partial claims because partial claims are quick, easy, and financially beneficial to the servicer. In addition, servicers are using partial claims instead of loan modifications because the modification process requires additional expertise and resources, and can present a financial risk to the servicer.

HUD needs to develop a process for the collection of defaulted partial claim notes

Third, HUD is required to develop a process to collect and report defaulted debts in a manner that protects the value of the Government's assets. HUD had $2.4 million in uncollected notes that were due for 448 loans that were terminated between September 1997 and May 2001. HUD has not ensured the assets of the government are being protected because it does not have an effective system to collect notes that are not paid during the sales or refinance transaction. HUD has relied solely on the recording of second mortgages to facilitate the collection of partial claim notes during the sales or refinance transaction. However, following this requirement does not guarantee repayment because: (1) liens for partial claim loans are not recorded in Texas; (2) closing agents are missing the recorded document because of confusion with its title; (3) closing agents do not know where to send the pay-off monies; and (4) possible timing issues that may occur from a sale of the property immediately after a partial claim payment. Furthermore, HUD does not have a process to report delinquent notes in HUD's credit alert system, which would help facilitate repayment of the note if the borrower tries to participate in another Federal credit program.

HUD's monitoring and oversight of FHA Servicers' Loss Mitigation Program provides limited assurance that HUD is achieving its goals

Fourth, HUD has not performed sufficient monitoring and oversight of large servicers and FHA servicers are not consistently administering the loss mitigation program because current guidance is unclear, inconsistent, or does not address issues identified by servicers. Consequently, HUD has limited assurance that the Loss Mitigation program is maximizing home retention and reducing cost to the FHA Insurance fund.

We believe that the effectiveness and efficiency of the loss mitigation program can be improved by:

- Emphasizing to servicers the need to use good business judgment, based on expertise and past experience with delinquent borrowers, when allowing borrowers to participate in the loss mitigation program;
- Reducing loss mitigation processing timeframes;
- Requiring borrowers to make a good faith effort of three payments before completing a partial claim;
- Improving the process for implementing loan modifications;
- Ensuring that partial claims are only used when appropriate;
- Improving the process for collecting partial claim notes;
- Reporting defaulted partial claim notes in HUD's credit alert system;
- Increasing monitoring and oversight of lender servicing operations;
- Establishing better communications with servicers to enhance polices and procedures for implementing loss mitigation; and
- Using knowledge and data gained from monitoring reviews to identify policies and procedures enhancements to improve the current implementation of the loss mitigation program.

Auditee comments

The Assistant Secretary for Housing - Federal Housing Commissioner provided written comments to our draft report on January 15, 2002. The Assistant Secretary generally concurred with our audit results and agreed to implement a number of actions to respond to the issues identified in our report. We considered HUD's written and verbal comments to the draft report, and made the appropriate changes to the final report. The Assistant Secretary's comments are included in its entirety in Appendix 1.

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# Introduction

## *BACKGROUND*

Until its termination, FHA's loan assignment program was the primary alternative to foreclosure for many FHA borrowers experiencing financial difficulties. HUD's Assignment Program was terminated on April 26, 1996 by the enactment of the Balanced Budget Downpayment Act. Its replacement, FHA's Loss Mitigation Program, went into effect on November 12, 1996. The Loss Mitigation Program is expected to reduce the number of foreclosures and to significantly reduce costs associated with foreclosures. Stated goals of the Loss Mitigation Program are to keep homeowners in their homes, and to mitigate losses to the insurance fund.

Under the Loss Mitigation Program, FHA compensates servicing mortgagees for their actions to mitigate foreclosure losses through the use of specific loss mitigation tools. Servicing mortgagees can use the following five primary tools:

- Special forbearance
- Loan modification
- Partial claim
- Pre-foreclosure sale
- Deed-in-lieu of foreclosure

The first three tools are home retention tools and are designed to avoid foreclosure and to keep mortgagors in their homes. The latter two tools enable the mortgagor to avoid some of the consequences of foreclosure and to reduce the cost of the claim to FHA; however, the home is not retained. Our audit focused solely on the first three home retention loss mitigation tools, as this is one of HUD's primary goals for the program.

Servicing mortgagees are required to review the status of each defaulted loan in their portfolio, and to document their loss mitigation efforts. Although servicers have some flexibility in determining which tools to use, FHA requires that the servicing mortgagee consider all of the loss mitigation tools for delinquent loans.

The National Servicing Center, located in Oklahoma City, provides servicing and loss mitigation program services to lenders and borrowers throughout the country. The Center is a division of the Headquarters Office of Single Family Asset Management.

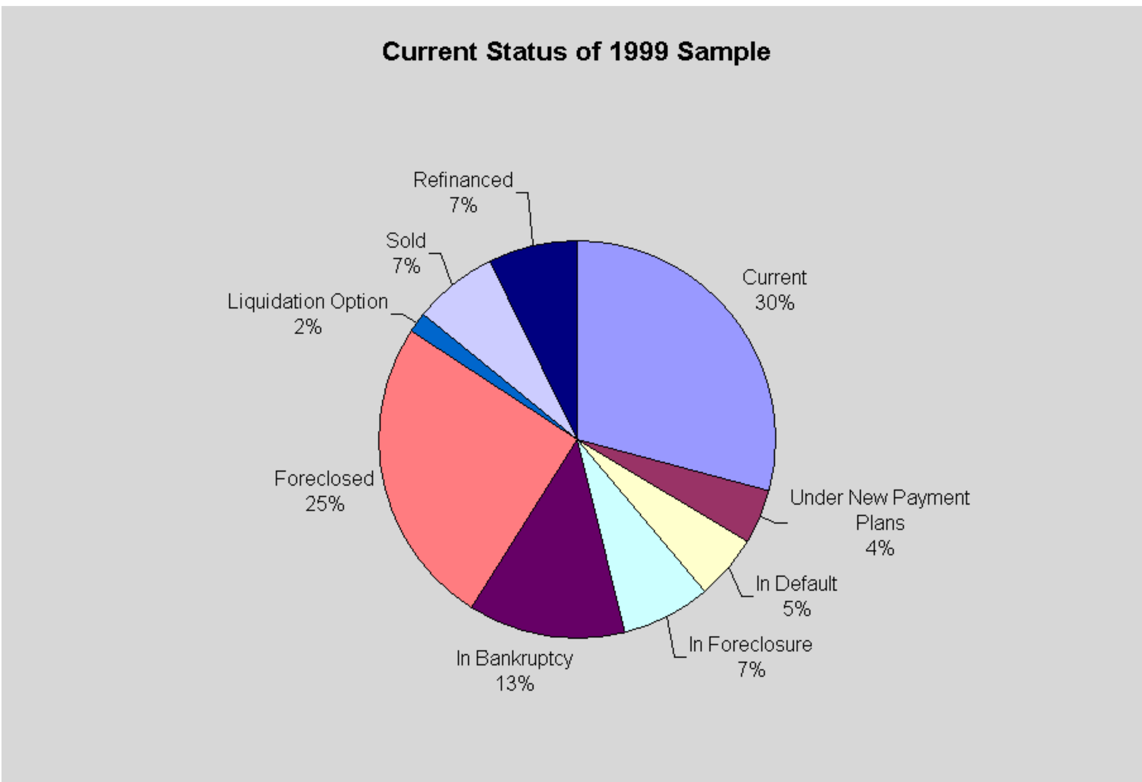
## *EVOLUTION OF THE PROGRAM*

In our 1999 report[1] we stated that we were unable to assess whether FHA's Loss Mitigation Program would ultimately reduce foreclosures and keep families in their homes because a majority of the loss mitigation actions taken at that time were still in process. Therefore, it was

[1] On September 30, 1999, the District Inspector General for Audit, Rocky Mountain District, issued audit report 99-DE-121-0001, Nationwide Review Department of Housing and Urban Development's Loss Mitigation Program.

not determined whether the loss mitigation actions taken would ultimately prevent borrowers from defaulting again or going into foreclosure. Although, we believe now that the program is reducing foreclosures and keeping families in their homes. Our focus during the follow-up audit was to identify ways to improve the effectiveness of the program.

We took another look at the loans sampled in 1999 to see whether their current status might tell us how the program was working at that time. Of the 178 loans sampled in 1999, 30% are current and the borrowers are still in their homes; 29% of the borrowers are still in their homes but they continue to struggle making their mortgage payments; 27% have been foreclosed, had a preforeclosure sale or deed-in-lieu of foreclosure; 7% were refinanced; and 7% have been sold. Since this sample was taken at the beginning of the loss mitigation program, it is not indicative of the current effectiveness of the program.




The utilization of home retention loss mitigation tools has continued to increase since our audit report in 1999. As reported in 1999, HUD had paid in excess of $26.9 million in loss mitigation claims for the time period October 1, 1996 to May 31, 1999. From June 1, 1999 to April 30, 2001, HUD has paid an additional $117.5 million dollars in loss mitigation claims. This dramatic increase was due largely in part to the increased usage of partial claims. The usage of partial claims is discussed in further detail in Finding # 2.

During our current review, we did site work at six large servicers and two mid-size servicers. HUD has paid these servicers for over 50,300 loss mitigation incentives, accounting for 56% of the total home retention options paid by HUD from the inception of the program through May 31, 2001. We reviewed the use of loss mitigation tools on a non-statistical sample of 210 loans at the eight servicers. We selected six servicers because they processed the highest number of loss mitigation claims, and selected two servicers because they used partial claims as their primary home retention loss mitigation tool. While the loans sampled do not provide a statistical basis for projecting results on the universe, the sample provides a reasonable basis for our conclusions.

Our audit period for the follow-up audit included May 1999 to April 2001. Mortgagee Letter 00-05 was issued in January 2000. This letter consolidated program instructions contained in five earlier Mortgagee Letters, and clarified issues raised by mortgagees. Therefore we looked at loss mitigation cases that were processed before and after the mortgagee letter. We observed a dramatic improvement in the implementation of the program during this period by the six large servicers. Each of these servicers was making a concerted effort to follow the framework of Mortgagee Letter 00-05 and had a strong desire to see the program work. In fact, some servicers have seen their loss mitigation departments move from cost centers to profit centers. We also noted better documentation and a reduction in the time to process loss mitigation workouts at one of the two mid-size servicers reviewed. The other mid-size firm informed us that it was going to sell most of its FHA portfolio.

FHA-insured loans require more resources to service than other loan portfolios. Several servicers' FHA portfolios consisted of between 21 and 33% of its total portfolio while their FHA loss mitigation workouts consisted of between 60 and 75% of its total loss mitigation workouts. The high percentage of loss mitigation workout rates relates to the high delinquency rates of FHA loans. At one large servicer, the July 2001 delinquency rates were 11.7% for FHA, 8.2% for VA, and 2.8% for conventional loans. Although, some of the servicers we spoke with thought that the FHA delinquency rates were artificially inflated due to the number of loans that are currently under loss mitigation repayment plans that do not fully reinstated the loan. The Mortgage Bankers Association recently reported that the overall delinquency rate on FHA single-family loans hit 10.79%, the highest rate since they began keeping records in 1972. The rate is likely to become higher due to the severe economic downturn the country is currently experiencing. As a result, the Department is bound to see a sharp increase in loss mitigation and foreclosure activity.

## Overall audit objectives and methodology

Our overall audit objective was to determine whether the Single Family Loss Mitigation Program is effectively and efficiently achieving HUD's goals for increased home retention and minimized costs to the insurance fund. While planning our fieldwork, we wanted to ensure that the loss mitigation program was not experiencing any of the same problems associated with the assignment program, which it replaced in 1996. Our 1996 audit[2] of the assignment program reported that:

> "One of the most significant problems with the assignment program was the failure to foreclose on properties once all forms of relief had been exhausted. Appropriate foreclosures ... assure seriously delinquent mortgagors who continue to

[2] Review of Selected Aspects of the Single Family Assignment Program issued April 2, 1996 (96-AO-121-0002)

occupy properties, are not subsidized for extended periods of time."

Therefore, we wanted to determine whether servicers are: (1) performing due diligence when servicing delinquent loans and approving qualified borrowers for loss mitigation; and (2) taking appropriate actions to apply disposition options or initiate foreclosure when it's clear that the borrower is either unable or unwilling to pay their mortgage. In addition, we reviewed (1) the collection process for overdue partial claim notes; (2) HUD's quality assurance over the loss mitigation program; and (3) the corrective actions that were implemented in connection with our prior audit report issued on September 30, 1999. To accomplish these, we:

- Reviewed the law and regulations governing the loss mitigation program;
- Interviewed various HUD officials from Single Family Program offices and the National Servicing Center, and mortgage servicing officials;
- Performed on-site reviews at eight FHA-approved mortgage servicers that have implemented loss mitigation procedures and at HUD's contractor for servicing partial claim notes;
- Reviewed a select sample of FHA loan cases;
- Reviewed supporting documentation within the case files and related computer records;
- Evaluated the current status of FHA loan cases reviewed during the 1999 audit, if applicable;
- Assessed the selected servicers' quality control plan;
- Analyzed data and statistics relating to the selected mortgage servicers' loan portfolio, if provided; and
- Reviewed quality assurance reviews of the loss mitigation program.

**HUD and mortgage servicer data systems used**

To achieve our audit objective, we queried data within HUD's Single Family Data Warehouse; specifically, information downloaded from the Single Family Default Monitoring System and the Single Family Insurance System and Subsystem. This data is maintained by HUD. We analyzed the data to identify potential problem areas to review when doing our site work. We did not perform a detailed analysis of the reliability of the HUD data. Although, for the loans sampled we verified pertinent data obtained from these systems.

**Scope**

Our audit covered the period of May 1, 1999 through April 30, 2001. Where applicable, the audit period was expanded to include past and current data, due to prior and continuing actions. We conducted our fieldwork from June 2001 through October 2001.

Generally Accepted Government Auditing Standards

We conducted the audit in accordance with Generally Accepted Government Auditing Standards.

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# Program Effectiveness Can Be Improved by Servicers Exercising Good Judgment to Cease Delaying Foreclosure Process and by Reducing HUD's Required Loss Mitigation Timeframes

**HUD delegates servicers to use good business judgment to ensure that the selected loss mitigation workout options reasonably reflect the borrower's ability to pay. We found that servicers were performing due diligence when servicing delinquent loans and approving qualified borrowers for loss mitigation. However, three of the large servicers were approving multiple loss mitigation tools, even when they believed the workouts would not succeed. Consequently, these actions are delaying the foreclosure process, increasing the cost of foreclosure, and subsidizing borrowers who do not pay their mortgage for extended periods of time. Servicers interpreted verbal instructions provided by HUD's National Servicing Center, to mean that virtually any interested borrower is permitted into the program. Servicers are reluctant to deny loss mitigation when it is prudent to do so because the servicer may have to indemnify the loan later if HUD disagrees with the decision.**

**Further delays are caused by HUD's requirements to wait 90 to 120 days before implementing loss mitigation tools, to wait 60 days before a broken special forbearance is considered a failure, and to wait at least 90 days to begin the foreclosure process after a loan is reinstated by a partial claim or loan modification. We identified multiple instances where borrowers are immediately going back into default after servicers fully reinstate their delinquency with a partial claim. To fulfill the goal of helping borrowers in default retain homeownership while mitigating the economic impact on the FHA insurance fund, HUD needs to: (1) clarify to servicers the need to consider all borrowers for loss mitigation and to ensure good business judgment is followed when determining whether the borrower qualifies for the program, (2) reduce the timeframes for processing loss mitigation, and (3) require borrowers to make a good faith effort of making three normal payments before completing a partial claim.**

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HUD delegates authority to servicers

In Mortgagee Letter 00-05, HUD delegates servicers both the authority and the responsibility to utilize actions and strategies to assist borrowers in default retain their homes and/or reduce losses to FHA's insurance fund.

Servicers are required to use good business judgment

Furthermore, Mortgagee Letter 00-05 requires servicers to use good business judgment. The letter specifically states:

> "*Lenders **may** offer FHA relief options to homeowners who have experienced a verifiable loss of income or increase in living expenses to the point where the mortgage payments are no longer sustainable*."
>
> "*The lender must use good business judgment to ensure that the workout option selected reasonably reflects the borrower's ability to pay*."

In addition, the Mortgagee Letter prescribes timelines that the lender must use before it can perform loss mitigation actions, consider a special forbearance a failure, and initiate foreclosure proceedings.

When an FHA-insured loan becomes delinquent, lenders may utilize any of the loss mitigation strategies that are appropriate under the circumstances. To make this determination, servicers analyze the borrowers circumstances by reviewing: the reason why the borrowers are unable to pay their delinquency, financial information, credit history, debt, HUD guidelines, and other appropriate information. Servicers are to use their best judgment based on this analysis to make a reasonable determination as to whether a loss mitigation strategy will work or not. HUD also has prescribed timelines that the lender must adhere to while processing loss mitigation strategies or foreclosures. Servicers are performing due diligence when servicing delinquent loans if they complete the aforementioned process in a timely manner.

Problems reducing program effectiveness

We found that the servicers we reviewed were performing due diligence when approving borrowers for loss mitigation the first time. However, we found that three large servicers were approving multiple loss mitigation tools, even when they believed the workouts would not succeed. Consequently, these actions are reducing program effectiveness by delaying the foreclosure process, which increases the cost of foreclosure and subsidizes borrowers who don't pay their mortgage for extended periods of time. We believe that program effectiveness is also reduced by additional delays caused by HUD's requirements to wait 90 to 120 days before implementing loss mitigation tools, to wait 60 days before a broken special forbearance is considered a failure, and to wait at least 90 days to begin the foreclosure process after a loan is reinstated by a partial claim or loan modification.

Preliminary analysis of data identified potential problems

We analyzed the total loss mitigation claims paid through May 2001 using HUD's Single Family Data Warehouse and identified over 700 loans, which have had three or more home retention loss mitigation actions. Although this accounts for less than one percent of the total incentives paid, we wanted to review the circumstances of these borrowers to determine whether multiple loss mitigation actions were justified or if there is a systemic problem that is allowing poor candidates to continually be approved for loss mitigation. We identified a number of cases where the borrower, without making any payments, immediately went back into default after receiving home retention loss mitigation.

Servicers not using good judgment when approving borrowers after prior loss mitigation actions failed

We evaluated a total of 65 loans that had multiple home retention options at the servicers we reviewed. We found that some servicers made prudent decisions to recommend disposition options to the borrower or began foreclosure proceedings after it became clear that additional workouts were not going to help the borrower. However, three large servicers were reluctant to make prudent business decisions and they continued to approve borrowers for loss mitigation even when they believed the workouts would not work. Consequently, the multiple loss mitigation actions were in effect delaying the foreclosure process, increasing the cost of foreclosure, and subsidizing borrowers who do not pay their mortgage for extended periods of time.

Servicers believe they cannot use good business judgment

Although the mortgagee letter informs a servicer to use good business judgment, a servicer told us that staff from the National Servicing Center has verbally given them a different message during its training seminars. A vice president at one servicer told us that during a recent training HUD staff emphasized that, as long as the mortgagor has an increase in expenses or decrease in income, no matter what the reason, the mortgagor **must** be considered for a loss mitigation tool. The servicer expressed a major concern that the servicer lacked the discretion to limit the number of loss mitigation tools that are used to service a mortgagor's loan.

Everyday the servicer receives cases where the mortgagor has already had multiple workouts. HUD staff has verbally instructed the servicers not to make loss mitigation decisions based on a mortgagor's lifestyle or financial decisions. Prior to the Mortgagee Letter 00-05, the servicer based its decision for using loss mitigation on a hardship evaluation. HUD has communicated to the servicer several times that the servicer will not use the term *"hardship"* in regards to the delinquent borrowers financial status.

The servicer believes they made better business decisions to approve loss mitigation when they were evaluating the reasons why borrowers became delinquent.

Borrowers should have a hardship in order to participate in the program

In our opinion, servicers should be allowed to determine whether the borrower had a hardship when exercising good business judgment. Otherwise the Department is only encouraging irresponsible behavior. For example, we reviewed a case where the borrower's hardship letter explained that their increase in expenses was due to gambling losses. Since the borrower had an increase in expenses, the servicer felt obligated to approve a partial claim. The borrower subsequently filed for bankruptcy protection. In another case, a servicer granted loss mitigation to a borrower who was current on their Mercedes payments but was not making payments on the less expensive home mortgage.

A first vice president of another servicer told us that HUD criticized it for not doing enough for borrowers whose expenses increased and income decreased. The HUD National Servicing Center told the servicer to make it work. HUD instructed the servicer that if a borrower meets all of the guidelines for a specific loss mitigation tool, the servicer could not deny the loss mitigation action, even though past experience shows that a borrower under the same circumstances will default again, resulting in foreclosure. The first vice president said that the servicer has to do what HUD says, because the servicer has not been given any authority or charter to make decisions. The servicer would like to see the initiation of more discretion by HUD to the loan servicer on whether a borrower should be given additional chances to correct their delinquency. If the loss mitigation tool or tools do not work based on the circumstances, then the servicer should end the process.

Finally, a senior vice president of a third large servicer said there are borrowers who learn the system and take advantage of it, as well as borrowers who do not want to deal with the fact that they are defaulting on their mortgage and may lose their home. The servicer believes they should be able to look at the behavior patterns of the borrower and decide on no more workouts when the behavior indicates that the borrower is going to default again. The servicer believes, in these instances, that providing the loss mitigation tool is just delaying the inevitable.

HUD needs to clarify instructions

These servicers stated to us that they interpreted instructions from the National Servicing Center that any borrower who has had either an increase in expenses or decrease in income must be approved regardless of the borrower's hardship or circumstances. Such action only delays the foreclosure process.

Using this criterion, virtually every interested delinquent borrower qualifies for loss mitigation. The servicers are reluctant to use good business judgment because HUD may require them to indemnify the loan if loss mitigation is denied. Consequently, servicers are delaying the foreclosure process, which increases the cost of foreclosure, and subsidizes borrowers who do not pay their mortgage for extended periods of time.

A HUD official with the National Servicing Center told us that trainers tell servicers that they must consider all borrowers for loss mitigation but are to use their best judgment when determining whether a loss mitigation tool is beneficial and warranted. If HUD expects the program to succeed, HUD needs to clarify instructions to servicers to eliminate the misunderstanding or perception that is preventing servicers from using good business judgment when working with delinquent borrowers.

A HUD official advised that one of the biggest problems with the assignment program, which the loss mitigation program replaced, was the different ways that the field offices applied it. For example, some field offices were very diligent in permitting borrowers into the program while other offices had very liberal policies and let almost anyone participate. Indications are that differing interpretations of HUD requirements by servicers, as previously discussed, may be creating a similar problem with the loss mitigation program.

Servicers performing due diligence when approving borrowers for the first time

We also reviewed 105 cases where the borrower continued to miss mortgage payments after receiving home retention loss mitigation assistance for the first time. The cases were reviewed to determine whether servicers are performing due diligence when approving borrowers for loss mitigation and are taking appropriate actions to apply disposition options or initiate foreclosure when it is clear that the borrower does not have the ability to pay their mortgage. We found that servicers were performing due diligence when approving the borrowers for loss mitigation. The servicers based their decisions on the information provided by the borrower. If the borrower does not have a past history of problems, the servicers are inclined to take the borrower's assertions at face value.

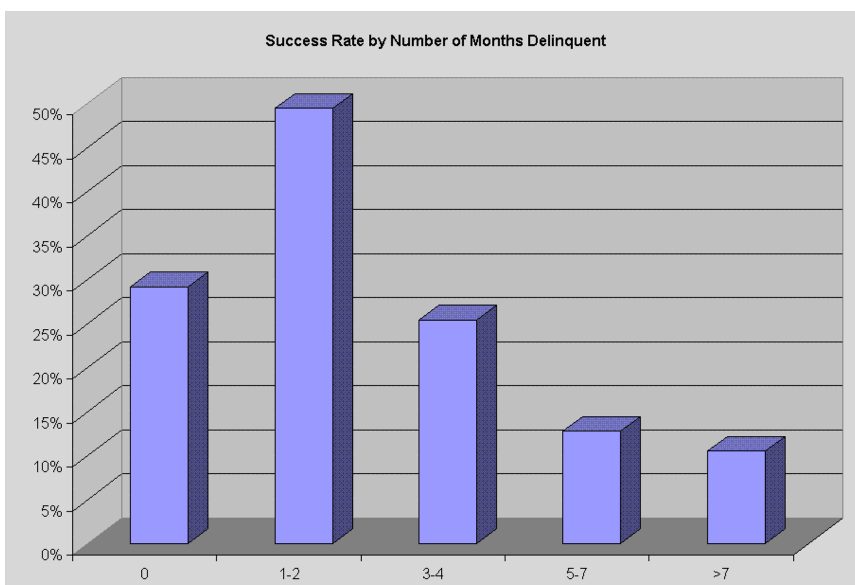
Program effectiveness depends on social factors that are not measurable

HUD commissioned a study by Abt Associates on the loss mitigation program. The Abt Associates report, issued in November 2000, stated that in order to evaluate program effectiveness, it is important to have information on current borrower circumstances, including their credit score, income, and expenses, as well as the property's condition and the current estimated loan-to-value ratio. However, we found during our review that the biggest factor in determining whether loss mitigation will be effective relates to social conditions, such as desire to maintain the home, family problems, drug or alcohol abuse, and gambling.

Several servicers have done extensive analysis of their data to identify statistical factors that may dictate whether a workout will be successful. One servicer told us that they found no correlations in its statistical information to identify workouts that may or may not succeed. Another servicer had some similar results. For example, the servicer did not identify any significant trends when analyzing success rates by the credit quality, age of the loan, loan-to-value ratio, interest rates, or surplus/deficit amounts. Although, the servicer found that when the borrowers surplus cash was higher than $1,000 the success rate started to drop. From this unusual trend, the servicer learned that they were not getting an accurate picture of the borrowers' actual expenses and instituted procedures to improve the gathering of expense related information.

Reducing timeframes may improve success of program

A servicer did learn that the success rate of loans on repayment plans dramatically dropped the longer the loan remained delinquent before the workout. The servicer is working on shorting the cycle and is currently processing workouts within an average of 22 days after contact with the borrower.



The chart shows the success of the servicer's December 2000 repayment plans, which includes both informal repayment plans and special forbearance plans. The plan was considered a success if, after three months, the borrower was current on the scheduled payments.

Other servicers agreed that the key to success for curing delinquencies is to get the borrower into a workout as soon as possible. The longer the loan remains in delinquency the harder it becomes to reinstate the loan, especially after the servicer begins the foreclosure process incurring foreclosure costs. Furthermore, taking too much time to reinstate the loans increases the likelihood that the borrower is either going to give up on the house or pursue other actions, like bankruptcy.

HUD requirements delay implementation of loss mitigation

Servicers can often determine within thirty days of delinquency, through contact with a borrower, that a repayment plan will not help the borrower. For example, if a borrower missed a payment due to a divorce. The borrower will have a permanent reduction in income and will unlikely be able to continue the present mortgage payments. If a loan modification will cure the situation, the need to delay 90 days before applying the tool is not beneficial. Or, if a borrower is on a fixed income and a medical bill caused a missed payment and a partial claim is the only solution, delaying the process for the 120 day period increases the cost. The earlier the delinquency is addressed the greater the chance for success.

Borrowers are manipulating circumstances and information

Due to HUD's 90 and 120-day requirements, some borrowers are withholding mortgage payments to qualify for assistance. Borrowers are getting loss mitigation information from the Internet or getting unscrupulous advice from housing counseling agencies. For example, a servicer informed us that a borrower was told by a counseling agency not to make any more payments in order to qualify for a particular loss mitigation tool. Also, we found notes, during one of our file reviews, where a borrower informed the servicer that their workout failed because a housing counseling agency advised the borrower to underreport their expenses to the servicer in order to qualify for the tool.

Several servicers also told us, based on information received off the Internet or from housing counseling agencies, borrowers are demanding certain loss mitigation tools. Servicers often do not explain all of the tools to the borrowers. The servicers only discuss the tool that the borrowers qualify for based on their financial condition and the hierarchy. The time requirements only encourage borrowers who are aware of the rules to intentionally skip payments to qualify for the tool they desire.

A HUD official told us that the Department is considering reducing the timeframe for loan modifications to 60 days, but it would be unable to change the 120-day requirement for partial claims without a change to the statutory requirement.

**Additional delays required by HUD**

Mortgagee Letter 00-05 states that option failure occurs for special forbearance when the mortgagor fails to perform under the terms of the written special forbearance agreement and the failure continues for 60 days. Several servicers advised that this requirement is permitting the borrower to stall the inevitable and ties the servicer's hands for two months. If the borrower breaks their repayment plan, the servicer should be permitted to immediately address the broken repayment plan and either put them on a better plan or option or initiate foreclosure proceedings.

Both loan modification and partial claim options fully reinstate the loan. In our opinion, these loans are artificially reinstated because the borrower did not make payments to cure their delinquency; rather, the borrower obtained relief in the form of modified loan terms or an interest free loan. For example, we reviewed a case where the borrower was seven months delinquent before receiving a partial claim that reinstated the loan. The borrower did not make any subsequent payments after the partial claim and after another 14 months the property was foreclosed.

If the borrower falls back into default, the servicer has to wait at least another 90 days before the servicer can initiate foreclosure proceedings since the loan was reinstated. If the borrower is unable or unwilling to fulfill their commitment, the servicer should be permitted to immediately initiate foreclosure proceedings. Any program changes relating to foreclosure timeframes would need to be communicated to the borrower and appropriate language to this effect should be incorporated into the agreements executed after the change.

HUD should consider requiring borrowers to make a good faith effort of making three normal payments before completing a partial claim. The good faith repayment plan is easily implemented by the servicers and would not add any additional costs to the Department. Furthermore, this process would limit the number of borrowers who immediately fail on their workouts because they do not have the means or desire to resume mortgage payments and save the Department the cost of a minimum of four payments that are capitalized in the loan. If HUD adopted this policy, the timeframes for implementing loss mitigation could be reduced without violating any statutory requirements. For example, a servicer places the borrower on a three-month payment plan after thirty days and then processes a partial claim. Thus, four months elapse before the partial claim is processed and there is no delay in processing loss mitigation.

We also identified instances where borrowers immediately became delinquent after receiving a loan modification. However, HUD officials advised that due to fluctuating interest rates it might not benefit the borrower to wait for a three-month repayment plan to conclude.

Suggestions to speed-up the workout process

A servicer offered the following suggestions to speed-up the workout process and to improve the program.

- If the reason for default is non-income related such as illness of a family member or excessive obligations, allow servicers to obtain a verification of income when the borrower verbally confirms that there is no change in income.
- Instead of mailing documents to borrowers for signature and return, allow servicers with the technical ability to use electronic transmissions using identification secured sites when borrowers have access to the Internet. Sending documents in the mail causes a large delay in the cycle time.
- If the borrower provides proof of marriage status with a divorce decree, allow servicers to accept only one signature when processing the documents for a loan modification or partial claim.

Unavoidable delays

Some delays are unavoidable. Several large servicers that we reviewed had between 5 and 8% of its portfolio of workouts currently under bankruptcy protection.

We found that large servicers were delaying the foreclosure process by approving multiple loss mitigation tools, even when they knew the workouts would not succeed. These actions are also increasing the cost of foreclosure, and subsidizing borrowers who do not pay their mortgage for extended periods of time. Servicers interpreted verbal instructions provided by HUD's National Servicing Center to mean that virtually any interested borrower is permitted into the program. Servicers are reluctant to deny loss mitigation when it is prudent to do so because HUD may ask the servicer to indemnify the loan.

Further delays are caused by HUD's requirements to wait 90 to 120 days before implementing loss mitigation tools, to wait 60 days before a broken special forbearance is considered a failure, and to wait at least 90 days to begin the foreclosure process after a loan is reinstated by a partial claim or loan modification. Furthermore, we identified multiple instances where borrowers are immediately going back into default after servicers fully reinstate their delinquency with a partial claim.

To fulfill the goal of helping borrowers in default retain homeownership while mitigating the economic impact on the FHA insurance fund, HUD needs to: (1) clarify to servicers the need to consider all borrowers for loss mitigation but to exercise good business judgment when determining whether the borrower qualifies for the program, (2) reduce the timeframes for processing loss mitigation, and (3) require borrowers to make a good faith effort of making three normal payments before completing a partial claim.

Auditee Comments

HUD generally concurred with the finding and agreed to continue efforts to train lenders on FHA's requirements for Loss Mitigation, encourage its use, clarify any questions arising about our policies and procedures, and resolve any real or perceived inconsistency in guidance issued by HUD. HUD stated that reducing the time before loss mitigation is used would required an in depth study taking into consideration potential budgetary impacts, regulatory restrictions and susceptibility to abuse. HUD further indicated they will carefully consider the suggestions made in the finding and any from the mortgage service industry to improve the program.

HUD's complete written response in shown in Appendix 1.

## Recommendations

We recommend that HUD:

1A. Emphasize and clarify instructions so servicers can use good judgment, based on expertise and past experience with the borrower, by:

- Clarifying to servicers the need to consider all borrowers for loss mitigation but emphasize that servicers are to use good business judgment to determine whether a loss mitigation tool is beneficial and warranted;

- Allowing servicers to consider whether the borrowers have a hardship beyond their control when qualifying them for the program; and
- Clarifying to servicers that HUD will not require them to indemnify a loan if they follow HUD requirements, use good business judgment and adequately document their decisions.

1B. Initiate actions to evaluate the reduction of the timeframes for processing loss mitigation tools. This would take into consideration:

- Reducing the number of days before servicers can use loss mitigation;
- Modifying the requirements so a special forbearance is considered a failure within a reasonable time after the borrower ceases making payments;
- Permitting servicers to start the foreclosure process after a loan is reinstated by a loan modification or partial claim when it becomes apparent that the borrower had no intention or ability to fulfill their commitment.

Based upon any processing changes made to the foreclosure timeframes, ensure the language of future agreements between the servicer and the borrower are appropriately changed or modified.

1C. Expand the partial claim option to include a mandatory three-month repayment plan to show a good faith effort that the borrower has the ability to pay.

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# The Costliest Option to the Insurance Fund Is Being Overused

**HUD requires that lenders use the hierarchy of loss mitigation option priority to help minimize losses to the insurance funds. The partial claim option, the costliest of the three home retention loss mitigation tools, is being overused. Out of the top twenty-five servicers with the highest percentage of loss mitigation claims, eleven used partial claims more often than loan modifications, three used them more than special forbearances, and four used them more often than both loan modifications and special forbearances. Thus, most large servicers relied more heavily on partial claims than they did on one of the other two home retention strategies. During our review, we identified instances where partial claims were granted for borrowers that would have qualified for one of the other two loss mitigation retention options. Servicers are relying on partial claims because partial claims are quick, easy, and financially beneficial to the servicer. In addition, servicers are using partial claims instead of loan modifications because the modification process requires additional expertise and resources, and can present a financial risk to the servicer. HUD needs to improve the loan modification process so servicers will be able to fully utilize the tool and require servicers to use partial claims only when appropriate.**

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HUD loss mitigation costs

In Mortgagee Letter 00-05, HUD communicates that the home retention loss mitigation options cost:

- $100 for a special forbearance or $200 for lenders with performance scores in the top 25%.
- $500 for a loan modification plus up to an additional $250 for the reimbursement of a title search.
- $250 for a partial claim.

In addition to the $250 incentive fee payment for a partial claim, HUD incurs an immediate cost for the interest-free loan provided to the borrower, which on average is about $6,000.

When an FHA-insured loan becomes delinquent, lenders may utilize any of the loss mitigation strategies that are appropriate under the circumstances. To make this determination servicers identify the cause of the delinquency and analyze the borrowers circumstances. Based on this analysis and the option hierarchy, the servicer determines which loss mitigation tool will best suit the borrower.

**Option hierarchy**

In Mortgagee Letter 00-05, HUD established an option hierarchy to help minimize losses to the insurance fund, one of the overall goals of the program. HUD requires that lenders determine that a special forbearance loss mitigation tool is not the best option prior to considering the use of a loan modification loss mitigation tool, and that a determination be made that a loan modification tool is not the best option prior to considering the use of a partial claim loss mitigation tool. Although, both a partial claim and a special forbearance will avert a foreclosure and reduce the potential loss to the insurance fund, a borrower-funded reinstatement through a special forbearance plan is less costly to HUD than a partial claim reinstatement that is funded by FHA.

**Special forbearance option**

A special forbearance plan can include a suspension of payments followed by a repayment plan. The borrower must have sufficient income to make payments that are greater than their normal payment in order to repay the delinquency. Borrowers who don't have sufficient income to make the larger payments can use either a loan modification or partial claim to fully reinstate the loan.

**Loan modification option**

A loan modification option reinstates the loan by capitalizing the delinquency under new loan terms. As a result, the modification permanently changes the terms of the loan resulting in payments the borrower can afford. When this loss mitigation strategy is appropriate, HUD requires servicers to ensure that the modified loan has first lien status. If other liens exist, they must be retired or the other creditors must agree to subordinate their claim. To protect HUD's first lien status, servicers may also record the modified loan.

**Secondary markets**

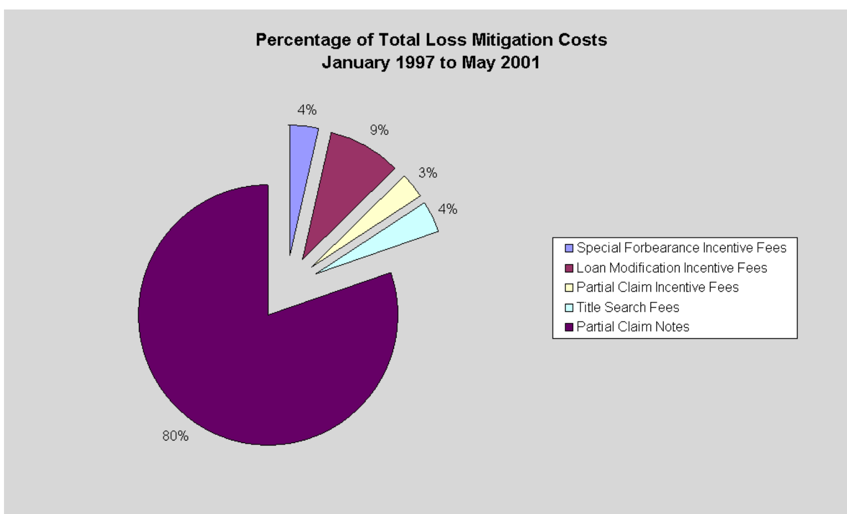
FHA-insured loans that are sold in the secondary market add additional requirements to the loan modification process. FHA mortgage loans are typically bought and sold in the secondary market, through the Government National Mortgage Association, also known as Ginnie Mae. Ginnie Mae is a division of HUD and guarantees mortgages insured by FHA, the Department of Veteran Affairs and the Rural Housing Service. Mortgage lenders obtain a guarantee from Ginnie Mae to finance or refinance FHA insured mortgages. After the mortgage is obtained, the lender pools similar mortgages and delivers the pool or block of loans to a securities dealer. The lender still is responsible for servicing the loans. Securities dealers then sell mortgage-backed securities, guaranteed by Ginnie Mae, to investors. The lender continues to collect monthly principal and interest payments from the borrower and forwards the funds to Ginnie Mae. Ginnie Mae disburses payments to investors. Ginnie Mae disbursements occur even if the payments have not been received from the borrower.

In order to modify a loan that is guaranteed by Ginnie Mae, servicers need to buy the loan back from the securities dealer. After the mortgage is modified, the lender again pools the mortgage with similar mortgages and delivers the pool or block of loans to a securities dealer. This action is called re-pooling the loan.

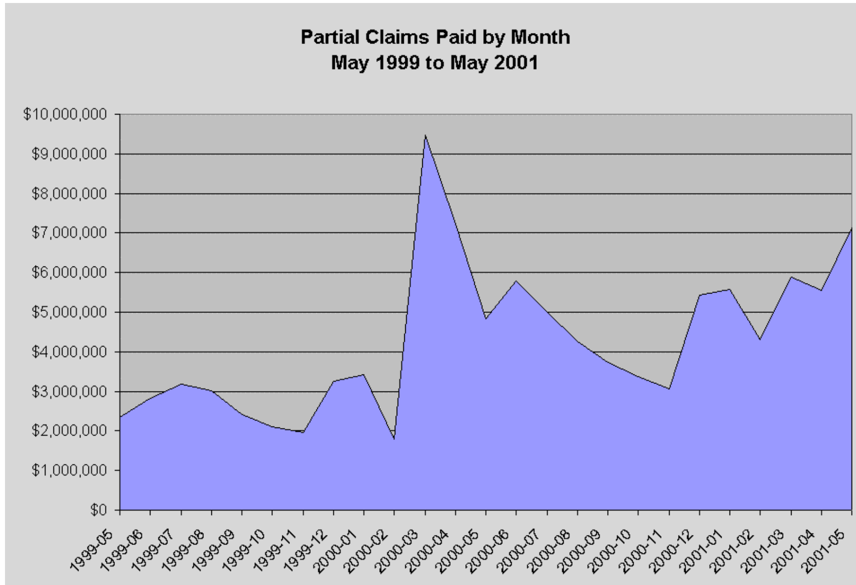
Conventional mortgages are also bought and sold in the secondary market, generally through the government-sponsored enterprises Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). Both Fannie Mae and Freddie Mac also encourage loss mitigation by mortgage servicers by offering incentives. These enterprises use loss mitigation tools similar to FHA's special forbearance and loan modification, however they do not endorse the utilization of partial claims.

Partial claims are the costliest option

The partial claim option, the costliest of the three home retention options, fully reinstates the loan with an interest-free loan to the borrower from HUD with monies from the FHA insurance fund. The partial claim option is rapidly growing. When we first looked at the program in 1999, HUD was paying under $3 million a month in partial claims. Two years later HUD is paying over $7 million a month; and has paid over $122 million since the inception of the program, four years ago. As of May 2001, partial claims accounted for 83% of the total cost of the loss mitigation program as shown below.



The chart below shows the history of monthly partial claim payments.

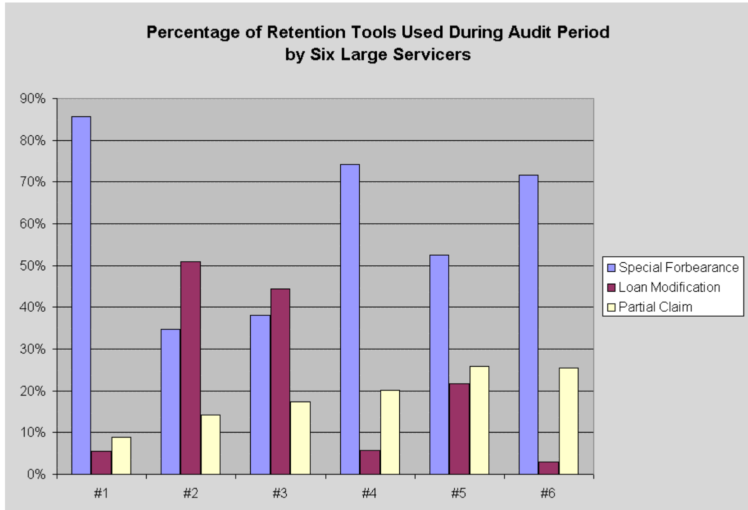



Servicers not following option hierarchy

We found that many large and mid-size servicers relied more heavily on partial claims than they did other retention tools. Our analysis of retention tool usage by servicers showed that eighteen of the twenty-five servicers[3], with the highest volume of loss mitigation incentive payments, used partial claims more than one of the other two home retention tools. Eleven of the servicers used partial claims more often than loan modifications, three used them more often than special forbearances, and four used them more often than both special forbearances and loan modifications.

We found during our preliminary analysis of the loss mitigation data of the six large servicers we selected for review, that four of them used partial claims more often than loan modifications. As the chart on the next page shows, usage of loss mitigation retention tools by these servicers over the same period of time varied widely. Additionally, we specifically selected two mid-size servicers for on-site reviews because partial claims were basically the only loss mitigation option utilized. The first servicer used partial claims exclusively and the second used it 97% of the time.

[3] These 25 servicers accounted for 88% of the total loss mitigation home retention usage through May 2001.




Two large servicers are using loan modifications, quite successfully, while the others are not fully utilizing the tool. Four out of the six large servicers we reviewed used partial claims more often than loan modifications. As a result, there is a higher reliance on partial claims to fully reinstate a loan. We identified instances at three of the large servicers where another tool could have been used instead of a partial claim. For the two large servicers that fully utilize the modification tool, one had a 62% success rate for the modifications it executed within the last twelve months ending July 2001 and the other had a 55% success rate for all of the modifications it executed to date. In comparison, one large servicer's success rate[4] for partial claims done to date was 34%.

During the scope of our review the average interest rate on 30-year fixed-rate mortgage varied between 6.78% and 8.55%. When interest rates were favorable we expected loan modifications to significantly increase. We found this true for two of the large servicers we reviewed but not the other four. We looked at the number of loan modifications done each month by the six large servicers. Two of the servicers, with the highest usage of loan modifications, processed a large number of modifications when rates were low and showed a dramatic decrease in modifications during a seven-month period when rates exceeded 8%. The other four servicers usage of loan modifications remained relatively unchanged for the whole two-year period. Thus, they were processing the same number of loan modifications when rates were low as they did when rates were high.

[4] Most servicers were unable to track partial claims in their systems, so they couldn't provide us with statistical data.

Over reliance on partial claim increasing cost

Servicers are over relying on partial claims, which increase the costs to the insurance fund to the greatest extent. The cost of the other two loss mitigation options is currently about $1.2 million a month, which minimally impacts the insurance fund. Whereas, partial claims currently cost about $7.4 million a month, which has more than doubled in the last two years. Although partial claim notes are loans that should be repaid at the end of the mortgage period, they can tie up resources for up to thirty years.

Loan modifications are not utilized because servicers are required to buy loans from Ginnie Mae pool

The primary reason cited by large servicers for utilizing partial claims to fully reinstate loans was their inability to efficiently use loan modifications. One large servicer told us that out of the three home retention tools, they like the modification option the best. However, it is the tool they use the least, because redelivery instructions from Ginnie Mae impeded the re-pooling process. They do not have these types of issues with the loan modification tools offered for conventional loans because Freddie Mac and Fannie Mae instructions make it easier to use, as further discussed below. Also, a large servicer told us the interest rates that existed during our audit period would have increased a borrower's mortgage payment, further hindering their financial situation; adding that with today's lower interest rates the servicer should be able to do more loan modifications. Similarly, another servicer told us the servicer would incur a marketing loss when re-pooling the loans due to the interest rates.

Ginnie Mae does not have a source of funds to internally pool loans

An FHA official explained to us that both Freddie Mac and Fannie Mae have procedures to internally re-pool loan modifications, while Ginnie Mae does not have a process to do so. Ginnie Mae attorneys told us that unlike Freddie Mac or Fannie Mae they are not an investor but are the guarantor of the Ginnie Mae portfolio. Thus, they do not have a source of funds to buy the loans from their investors to pool them internally. In order to buy loans out of the pool, the servicers need to have adequate liquidity. Then, depending on the interest rate on the date the loan is re-pooled, the servicers can experience either a gain or loss. One solution that HUD could consider to simplify this process is to request an appropriation of funds to buy loans out of the pool while they are being modified. Thus, HUD could act like a temporary clearing house for the modified loans.

Loan modifications are not utilized because of problems clearing second liens

Another large servicer told us that the primary reason that its loan modifications failed was because of second lien issues. Borrowers who are having trouble making their mortgage payments may not be able to afford to pay-off their second loans. The servicer also frequently experienced big delays when trying to process loan modifications because the servicer has to check the title, then if there is a subordinate lien on the property the servicer has to work to get it cleared, and then the servicer has to take time to get the documents recorded. To protect first lien status, HUD requires that servicers record modified loans only when required by the State where the property is located. The servicer emphasized that if the loan modification process were streamlined, servicers would use the option more frequently.

Freddie Mac has streamlined the loan modification process for its loss mitigation program

Freddie Mac has simplified its loss mitigation loan modification process by permitting servicers to obtain a Mortgage Priority Guarantee[5], similar to a title policy, to guarantee that executing a loan modification agreement will not effect the beneficiaries' lien position. The guarantee allows servicers to process loan modifications without clearing the second liens and costs seventy-five dollars. Freddie Mac has further streamlined the process by not requiring servicers to record loan modifications if the amount capitalized is less than $15,000, the time the loan is extended is less than seven years, and the interest rate is unchanged.

Partial claims are quick and easy

We visited two mid-size servicers to determine why they were primarily using partial claims. The first mid-size servicer told us that it was an executive decision to use partial claims because they were the quickest and easiest solution. The servicer explained that partial claims are more appealing to the mortgage company because there is no risk, unlike loan modifications that have re-pooling issues. Also, partial claims don't require the amount of tracking that the special forbearance requires. Furthermore, partial claims are more appealing to the borrower because it is a quick fix.

The second mid-size servicer told us that it primarily used partial claims because it brings the loan current and is the easiest for the borrower. The special forbearance was not typically used because the borrower usually did not have adequate income to make larger payments. Also, loan modifications were not used because the loss mitigation staff had not been trained to process them. The servicer processed special forbearances for the first time in 2001 and has done a total of sixteen compared with 231 partial claims during the same period.

We reviewed forty loss mitigation files for these two servicers and found that 26% of the borrowers would have qualified for one of the other two loss mitigation retention options. Furthermore, by the time the servicers processed loss mitigation workouts for two-

[5] The Mortgage Priority Guarantee is currently recognized in 43 states.

thirds of the cases we reviewed, the borrowers' delinquencies were over eight months making it difficult to use a special forbearance.

A servicer informed us that if the loan was financed with bonds it could not be modified. Furthermore, as described in the mortgagee letter, loan modifications would not always replace a partial claim:

> *"Loan characteristics which best support modification include: loans with above market interest rates; lower loan to value ratios; and/or mature terms (loans paid down 10 years or more). The modification tool is valuable when the arrearage can be capitalized into the loan balance, the term extended and/or the interest rate adjusted to current market rate, so that the resulting monthly payment is at a level the borrower can afford."*

**Improvements to the loan modification process will encourage servicers to use partial claims only when appropriate**

Servicers are relying on partial claims because partial claims are quick, easy, and financially beneficial to the servicer. Also, servicers are using partial claims instead of loan modifications because modifications are more difficult to process and can present a financial risk to the servicer. The Department needs to improve the loan modification process so servicers will be able to fully utilize the tool and require servicers to use partial claims only when appropriate.

**Auditee Comments**

HUD agreed to prevent servicers from exclusively using partial claims by providing clearer guidance, improved targeting for identifying these servicers and lender outreach. HUD also plans on reviewing the actual cost effectiveness of the various options.

HUD stated in their response that the report was unclear whether your conclusion that partial claims are the costliest option considered the long-term success of the various options (and losses when a foreclosure occurs despite loss mitigation efforts), or focused only on the initial incentive outlays. For a thorough evaluation of program effectiveness, a comprehensive view is required. HUD is analyzing the limited historic data available and is still in the process of determining actual cost effectiveness for each loss mitigation option.

**OIG Evaluation of Auditee Comments**

We did not consider the long-term success of the various options due to the limited data that is available because the program is still relatively new. We focused on the initial outlay because it currently presents the greatest financial risk to the FHA Insurance Fund. We are concerned that if partial claim growth remains unchecked the percentage of fund resources tied-up in long-term notes receivable may adversely impact the fund.

HUD did not address in its response the complications that are limiting the usage of loan modifications by servicers. As the report shows, even when rates are favorable several of the large servicers we reviewed are failing to fully utilize this option.

HUD's complete response is shown in Appendix 1.

## Recommendations

We recommend that HUD:

2A. Review and evaluate the feasibility of improving the loan modification process by:

- Obtaining funds to purchase loans from Ginnie Mae investors so they can be modified;
- Using Mortgage Priority Guarantees to protect first lien status under appropriate circumstances and not recording the modified loan if the changes are within established parameters.

2B. Reemphasize instructions to ensure that servicers are using partial claims only when appropriate.

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# HUD Needs to Develop a Process for the Collection of Delinquent Partial Claim Notes

**Federal agencies are required to develop a process to collect and report delinquent debts in a manner that protects the value of the Government's assets. HUD had $2.4 million in uncollected notes that were due for 448 loans that were terminated between September 1997 and May 2001. HUD has not developed an effective system to collect notes resulting from partial claim loans that are not paid-off during a property sale or refinance transaction. HUD has primarily relied on the recording of second mortgages to facilitate the collection of partial claim notes during a property sale or refinance transaction. However, following this requirement does not guarantee repayment because: (1) Texas does not permit the recording of second mortgages; (2) closing agents are missing the recorded lien document because of confusion with its title; (3) closing agents do not know where to send the note pay-off monies; and (4) possible timing issues that may occur from a sale of the property immediately after a partial claim payment. Additionally, HUD does not report defaulted notes in HUD's credit alert system. Using the credit alert system will increase HUD's chances of collecting payment on the defaulted note when the borrower tries to participate in another Federal credit program. HUD needs to develop a process for the timely follow-up and collection of partial claim notes that are due, report defaulted note payments in HUD's credit alert system, and provide additional guidance or make appropriate program changes to eliminate problems in this area.**

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HUD is required to develop a process for the collection and reporting of delinquent accounts

OMB Circular A-129 stipulates that:

> "The Government must service and collect debts in a manner that best protects the value of the Government's assets."
>
> "Agencies shall establish an accurate and timely reporting system to notify collection staff when a receivable becomes delinquent. Each agency shall develop a systematic process for the collection of identified delinquent accounts. Collection strategies should take advantage of the full range of available techniques while recognizing program needs and statutory authority."

Furthermore, the circular requires agencies to use HUD's Credit Alert Interactive Voice Response System to identify delinquencies on Federal debt. HUD's credit alert system is also known as CAIVRS.

Partial claims are due when 1st mortgage is paid-off or refinanced

A partial claim is an interest-free loan provided by HUD to borrowers with monies from the insurance fund. A servicer/lender advances funds on behalf of a borrower in an amount necessary to reinstate a delinquent loan. The borrower, upon acceptance of the advance, will execute a promissory note and subordinate mortgage payable to HUD. HUD then reimburses the lender for the partial claim.

Normally, a partial claim note is due when the borrower pays off the first mortgage, which can take up to thirty years. Partial claim notes also come due when the borrower sells or refinances the property. We also learned from servicers that some borrowers pay-off their partial claim note early in order to get a second loan secured by the property, and the partial claim note lien needs to be removed before the creditor will approve the new loan. HUD also receives a pay-off on the partial claim if there is a preforeclosure sale.

HUD hired a private contractor to service the partial claim notes in April 1999. The contractor is maintaining: a system to keep track of partial claim notes; copies of recorded documents; and a toll free number to give pay-off information to closing agents and borrowers. Additionally, the contractor records partial claim note payments. The contractor also files a proof of claim with the court to protect the Department's interest when the borrower files for bankruptcy protection.

Note is secured by a lien on the property

HUD relies on the recording of second mortgages to facilitate the collection of the partial claim notes. The FHA lenders are required to execute a promissory note in the name of the Secretary and file a subordinate mortgage (Deed of Trust) with the county recorder's office to ensure the collection of partial claim notes.[6] When the property is sold or refinanced, the closing agent can learn that there is a subordinate note through a title search, or from the servicer or borrower. The closing agent remits the funds to the contractor who records the payment and sends it to a lockbox.

Delinquent notes

As of April 30, 2001, HUD has paid 19,421 partial claims, totaling $115 million. Most of the claims are still outstanding, but HUD has collected $7.6 million on the repayment of 1,299 notes. Servicers report to HUD that a loan has been terminated when the loan is paid-off, refinanced, matured or has a non-conveyance foreclosure. Therefore, if a borrower received a partial claim, HUD should receive a repayment on the partial claim note when the loan is terminated.

[6] The requirements are communicated in Mortgagee Letters 97-17 and 00-05.

We identified terminated loans with a previous partial claim and determined whether the contractor received a repayment. HUD had not received a pay-off from notes that became outstanding when 440 loans were terminated. Thus, HUD has $2,392,174 in uncollected notes that are due. The oldest of which was terminated in September 1997. Additionally, HUD has not received repayments on eight notes totaling $32,000 that became outstanding when borrowers had preforeclosure sales.

Government assets are not protected

Current controls implemented by the Department have not ensured that Government assets are being protected. Assets of $2.4 million were not collected because the Department has not implemented a system to collect notes that are not repaid during the sale or refinance transaction.

Difficulty in following-up on sales transaction

We selected a non-statistical sample of twenty sale transactions to identify causes for the nonpayment of partial claim notes. We requested closing agent information from the servicers who processed the partial claims, but none of them tracked the closing agent for a paid-off loan and could not provide us with enough information to follow-up on the transaction. We queried an independent Internet data system for information on the sale or refinance transactions, and identified several transactions for follow-up. We followed up on the transactions by contacting the title companies involved in the transaction, and were able to determine the reasons why the partial claim notes were not being repaid for seven of the twenty cases.

No process to collect delinquent notes

HUD does not have a process to collect notes that are not repaid after the settlement of the sale or refinance transaction and is relying on the recorded note to lead to repayment. We found that having the note recorded did not guarantee repayment. We identified four possible reasons why recording the note did not facilitate repayment of the loans: (1) second mortgages for partial claim loans are not recorded in Texas, (2) closing agents are missing the recorded document because of confusion with the document title, (3) closing agents do not know where to send the note payment, and (4) possible timing issues that may occur from a sale of the property immediately after a partial claim payment. The four causes for nonpayment of notes that we identified are further discussed below.

Liens are not recorded in Texas

First, according to the private contractor that is servicing the partial claim notes, the State of Texas does not allow subordinate or second mortgages to be recorded. A HUD official clarified that

HUD does not require a secondary lien for partial claim loans to be recorded in Texas because the Homestead Provision of the Texas Constitution prohibits it. To protect its interest, HUD requires borrowers to sign a promissory note. However, the only way that the closing agent becomes aware of the note is if the borrower or servicer informs the closing agent.

It is apparent that closing agents generally are not being informed of the promissory notes. As of May 2001, HUD has paid over $9 million in partial claims to 1,736 borrowers in Texas. One hundred and twenty-one of the first mortgages have since been terminated, of which HUD has not received repayment on 81% of them. Consequently, HUD has not collected $478,000 on partial claim notes associated with 98 properties. This accounts for twenty-two percent of the 440 uncollected notes.

Confusion with the name of the note

Second, there were several cases where the title search did not identify the partial claim note because the title company relied on information provided by a vendor that electronically compiled descriptions of legal documents from the county recorder's office. The title company researched the situation and determined that the vendor used the code for a subordinate agreement. Since subordinate agreements are inconsequential to the sales transaction, the closing agent did not request a copy of the recorded documents. The title company said that a number of title companies in that particular State used the same vendor.

Similarly, one title company believed that it missed the note because of the document wording. The partial claim note document is called a Subordinate Mortgage and in the State where this company is located, the word subordinate is usually associated with a Subordinate Agreement. Therefore, the mortgage was mistaken for an agreement.

Confusion with who to contact for pay-off

Third, a title company told us that it contacted the servicer of the seller's mortgage to determine where to remit the note payment. The servicer told the title company to contact a housing program administered by the City where the property was located. The borrower had received another grant from the City's HUD funded HOPE program to make the down payment on the purchase of the property. Both notes were called a subordinate mortgage. The title company contacted the staff at the City but the City did not know anything about the partial claim note. The title company has held the pay-off funds in escrow for seven months while waiting for someone to claim it.

Possible timing issues

Fourth, we identified cases where closing agents may not have been aware that a partial claim lien existed because of timing issues caused by the borrower selling the property immediately after receiving a partial claim loan. Thirty of the uncollected notes were loans that were paid-off within three months of the borrower executing the partial claim promissory note. Generally, there is a time lag between the time a borrower executes a promissory note and the time a lien is recorded and available for review by someone doing a title search. Also, it could take up to sixty-days before the servicer submits its payment request to HUD, and another month before the partial claim is processed and paid. Therefore, if there is an immediate sale after the borrower receives the partial claim loan, it is possible that there is no knowledge of the lien by the settlement agent because the lien has not been entered into the county recorders system, or by the contractor servicing the partial claim notes because of the time it takes both the servicer and HUD to process the note.

HUD report identifies delinquent accounts but there is no process to follow-up on exceptions

HUD began preparing a monthly exception report in December 2000 that HUD submits to the contractor servicing the partial claim notes for follow-up. The contractor told us that it started analyzing the exception reports after our audit started. The June 2001 error report showed that there were 430 loans that were paid-off with partial claim balances still outstanding. The error report also identified eight pay-offs from preforeclosure sales that were still outstanding. As of the time of our review HUD was still researching the situation whereby partial claim notes were not paid when HUD's systems showed that the loan was paid-off or had a preforeclosure sale. HUD had not devised a process for collecting the defaulted notes.

HUD Contractor not responsible for collecting delinquent notes

We provided the private contractor with the names of title companies that did not remit pay-off funds for partial claim notes, so that follow-up on the collection of these notes could be made. However, the contractor advised that they did not consider it their responsibility to make collection efforts since the collection responsibility is not part of their contract with HUD.

HUD's credit alert system may help recover delinquent payments

HUD's credit alert system has been expanded to include delinquent debt from other major credit programs in the Federal Government. All Federal Agencies with credit programs should be using HUD's credit alert system for loan screening to ensure applicants are not delinquent on Federal debt. Ensuring that borrowers who default on partial claim note payments are reported in the credit alert system may encourage repayment of the defaulted note when a borrower tries to participate in another Federal credit program.

Necessary servicing requirements are not communicated in contract

The primary purpose stated in the contract with the private contractor was to engage a loan servicing organization to perform a full range of comprehensive servicing of the Department's Secretary-held Single Family mortgage portfolio. In addition to servicing Secretary-held notes the contract calls for the servicing of partial claim notes. The contract states that partial claim subordinate mortgages have minimal servicing requirements. Specifically, the contract requires the contractor to:

> "Establish and service Loss Mitigation loans; perform initial and monthly accounting reconciliation's between Loss Mitigation claim payments and the A80N; respond to mortgagor inquiries; call loans; process payoffs; and produce accounting reports as specified by HUD."
>
> "Track receipt of Loss Mitigation legal instruments from mortgagees; verify that legal instruments are in compliance with HUD's model promissory note forms and HUD's model partial claim subordinate mortgage forms; notify mortgagees of legal instruments not received; notify the GTR of non-receipt of legal instruments within the HUD designated deadline; and produce accounting reports as specified by HUD."

The contract does not stipulate that the contractor collect defaulted partial claim notes or report delinquent notes into HUD's credit alert system. Without specific contractual requirements, HUD is hampered to hold the contractor responsible for carrying out these activities.

HUD needs to develop processes to ensure the collection and reporting of delinquent note receivables

HUD has not developed a process to collect partial claim notes that are not repaid after the settlement of a property sale or refinance transaction. HUD has relied on the recording of second mortgages to facilitate the collection of the partial claim notes. However, following this requirement does not guarantee repayment because: (1) second mortgages are not recorded in Texas; (2) closing agents are missing the recorded document because of confusion with its title; (3) closing agents do not know where to send the pay-off; and (4) possible timing issues that may occur from a sale of the property immediately after the borrower executes a promissory partial claim note. Furthermore, HUD does not have a process to report defaulted notes in the credit alert system, which would help facilitate repayment of the note if the borrower tries to participate in another Federal credit program. HUD needs to develop a process for the timely follow-up and collection of partial claim notes that are due, report delinquent notes in HUD's credit alert system, and provide additional guidance or make appropriate program changes to eliminate problems in this area.

Auditee Comments

HUD concurred with the finding and agreed to: develop procedures to identify partial claim notes that become due when the first mortgage is prepaid, revise the partial claim note servicing contract to require collection attempts, request funding so defaulted notes can be reported in HUD's credit alert system, review the feasibility of renaming documents and identifying the payoff recipient in these documents, and review the options for collecting unsecured notes in Texas.

## Recommendations

We recommend that HUD:

3A. Develop a process for the timely follow-up and collection of partial claim notes that are due.

3B. Develop a process to update HUD's credit alert system when partial claim notes default.

3C. Develop comprehensive procedures for administering or servicing partial claim notes and clearly communicate them in the contract if this function is going to continue to be contracted out.

3D. Research methods to best eliminate the: (1) lack of pay-off from borrowers in Texas; (2) confusion over the title of the recorded document; (3) confusion over where to send the pay-off; and (4) non-collection from borrowers who immediately turn around and sell a property after executing a promissory partial claim note. Based on this review, provide additional guidance and directives to the mortgage industry or make appropriate program changes to resolve these problems.

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# HUD's Monitoring and Oversight of FHA Servicers' Loss Mitigation Programs Provides Limited Assurance that HUD is Achieving Its Goals

**HUD has not performed sufficient monitoring and oversight of large servicers and FHA servicers are not consistently administering the loss mitigation program because current guidance is unclear, inconsistent, or does not address issues identified by servicers. Consequently, HUD has limited assurance that the Loss Mitigation program is maximizing home retention and reducing cost to the FHA Insurance fund. HUD needs to expand its monitoring and oversight of servicing operations, establish better communications with servicers to enhance polices and procedures for implementing loss mitigation, and use knowledge and data gained from monitoring reviews to further identify policy and procedural enhancements.**

## HUD's Loss Mitigation Program and Servicing Requirements

HUD communicates to servicers the statutory, regulatory, and administrative servicing requirements for the loss mitigation program in mortgagee letters. HUD issues new mortgagee letters to communicate changes or clarifications to the loss mitigation program.

HUD Handbook 4060.1 REV-1 shows that HUD must approve lenders that service FHA-insured mortgages. As a condition of HUD approval, servicers must maintain a Quality Control Plan for the servicing of insured loans. Some of the primary objectives of the control plan are to assure: compliance with HUD-FHA requirements; servicer's procedures are revised in a timely manner to accurately reflect changes in HUD-FHA requirements; and prompt and effective corrective measures are taken and documented when deficiencies in loan servicing are identified. Specific quality control plan requirements for loan servicing are also specified in this Handbook.

Servicers use the above directives to establish guidelines for their loss mitigation programs. To ensure they comply with HUD's directives, servicers must implement procedures to review their administration of the loss mitigation program.

**HUD routinely monitors approved servicers**

To assure that the servicer's practices are in compliance with statutory, regulatory, and administrative servicing requirements HUD routinely monitors the servicing performance of approved servicers. Monitoring is also a management control technique for overseeing effective program administration. The Office of Housing's Office of Lender Activities' Quality Assurance Division determines the appropriate level of monitoring to ensure statutory and regulatory compliance of FHA programs, as well as efficient and effective program operations. The Quality Assurance staff in Headquarters, which is responsible for policy and oversight, target lenders for review. The Quality Assurance staff of the Homeownership Centers normally performs these reviews. However, HUD engaged a contractor in September 1999 to augment its servicing reviews. These reviews cover all aspects of loan servicing, with special attention to loss mitigation efforts.

**Servicers targeted by Headquarters**

The Quality Assurance Division in Headquarters targets servicers for review by separating the servicers into four categories by size (large, medium, small and very small); analyzing the servicers in each group by defaults, claims and usage of loss mitigation; and identifying when it last did a review of the servicer. Based on an analysis of this information, the officials select servicers that represent the greatest risk. Quality Assurance officials in Headquarters stated that quality assurance personnel in the HUD Homeownership Center field offices are to perform reviews of large or complex servicers and the private contractor is primarily to review small and mid-size servicers.

**HUD needs to improve its guidance, monitoring, and oversight of program**

Although HUD has implemented good quality control procedures, we identified issues that reduce HUD's efforts to quickly identify overall program weaknesses or weaknesses in how specific servicers are implementing the program. In particular, HUD has not performed sufficient monitoring and oversight of large servicers. In addition FHA servicers are not consistently administering the loss mitigation program because current guidance is unclear, inconsistent, or does not address issues identified by servicers. Consequently, HUD has limited assurance that the Loss Mitigation program is maximizing home retention and reducing cost to the FHA Insurance fund.

**HUD allocates few monitoring resources to servicing reviews**

Quality assurance reviews primarily focus on loan origination. HUD has historically divided lender monitoring activities between loan origination and loan servicing. During our audit period, there have been 2,012 lender origination reviews and 60 lender servicing reviews performed. Thus, HUD is targeting 97% of its resources to monitor the loan origination process. Monitoring reviews of lender servicing include a number of aspects of which loss mitigation is one. The loss mitigation program has added a completely new dimension to FHA loan servicing. Therefore, servicing reviews have become more critical, especially since the loss mitigation program is still evolving. While, we agree that loan origination presents the greatest risk to the FHA Insurance fund, the use of loss mitigation represents a tool to diminish the risk.

Monitoring focus on servicers not utilizing program

The servicing reviews consistently identified findings related to noncompliance with HUD's Loss Mitigation Mortgagee Letter 00-05. The more common findings included no loss mitigation attempts, documentation of loss mitigation inadequate, and untimely loss mitigation actions. The reviews identified that forty-five servicers, or 73% of the servicers reviewed, had deficiencies implementing the loss mitigation program.

The enforcement tool currently used by the Department to discourage servicers from ignoring loss mitigation is loan indemnification. Under a loan indemnification, the servicer agrees to compensate HUD for the insurance claim on a property where the servicer did not give the borrower an opportunity to participate in the program. Thus, HUD's primary focus in regards with servicing monitoring reviews has been to encourage servicers, who have not satisfactorily implemented the loss mitigation program, to use it.

Monitoring focus should be on improving the program

The seventeen largest lenders, with FHA portfolios of 100,000 or more, are servicing seventy-three percent of all FHA loans. During our audit period, the Department has done servicing reviews at only five of the seventeen large servicers. Consequently, HUD has not monitored lenders who service sixty percent of the FHA portfolio. Although it is important to monitor the servicers who are not making an effort to offer loss mitigation, the success of the loss mitigation program is largely dependant on how these large servicers administer the program.

While monitoring large servicers, HUD has an opportunity to learn how the program is actually working in some of the best environments, and how program design is causing roadblocks that are decreasing program effectiveness and causing inefficiencies. As a result, the Department will be in a better position to identify systemic or programmatic problems, improve guidance, and make appropriate changes.

Two servicers primarily used partial claims

As discussed in Finding 2, during our analysis of loss mitigation usage we identified two mid-size servicers that were relying primarily on the partial claim option. These servicers were not exercising due diligence since they were only utilizing one tool. By considering a servicer's usage of loss mitigation tools when targeting servicers for review, HUD could better target servicers who may not be administering the program as intended.

HUD should use data to identify trends and issues

Once a servicing review is completed, HUD staff enters the findings into the Approval/Recertification Review Tracking System using violation codes. The database provides a collection of all identified servicing findings by lender. A Quality Assurance official told us that the tracking system could provide a basis to identify weakness and trends in the loss mitigation program. The official advised that HUD used violations in the system to identify trends in loan origination reviews, but not in loan servicing reviews.

The Department is currently in the process of building performance reports for loan servicing into Neighborhood Watch. HUD plans on using the data to identify patterns. The new reports are to be available some time in 2002. These reports are planned to assist servicers in self-policing loss mitigation activities. In our opinion, HUD could also use information from its Review Tracking System to identify trends and areas of weakness in the loss mitigation program. Based on analyses of this information the Department could better target servicers for review, provide additional guidance to servicers, and make appropriate program changes.

Internal servicer quality control reviews

Lenders are required by HUD to internally monitor their servicing operations. The servicers use a Quality Control Plan to describe how the internal reviews will be done and HUD evaluates these plans during servicing reviews. To accomplish this servicers prepare a Quality Control Plan, which HUD reviews when it monitors servicers.

We reviewed sections of the quality control plans relating to the loss mitigation program and recent quality control reviews at five of the large servicers we reviewed. We found that there was a wide range between the plans and the tests that each servicer performed. Some servicers were doing very in depth quality control reviews, while some were covering the basic requirements. One servicer had not implemented any procedures to review loss mitigation activities. The servicer that was not doing an internal review of the loss mitigation program told us that HUD has not provided them with any guidance on what needs to be reviewed and the servicer is still in the process of developing procedures. Additionally, we found that one of the two mid-size servicers that we reviewed had not implemented quality assurance procedures for the loss mitigation program.

**Quality control guidelines are needed for the loss mitigation program**

The quality control requirements established in HUD Handbook 4060.1 REV-1 - Chapter 6, were issued in 1993, several years before the implementation of the loss mitigation program. The quality control requirements have not been updated to include the loss mitigation program.

During our review, we found that HUD has provided limited guidance regarding the quality control requirements for the loss mitigation program. We found that some servicers had taken the initiative and incorporated steps within their quality control plan to cover loss mitigation activities. These servicers are attempting to be conscientious and cover all aspects that may relate to quality control over loss mitigation activities. While on the other hand, we found servicers who had not taken the initiative to incorporate loss mitigation activities in their quality control reviews. The servicers we reviewed would like HUD to provide guidance as to the quality control requirements for the loss mitigation program. According to a servicer's quality control analyst, the servicer is having trouble obtaining clarification of program requirements and often receives conflicting information from HUD staff.

**Internal servicer quality control reviews are beneficial to HUD**

Internal servicer quality control reviews are an excellent tool for improving administration of the loss mitigation program. Some servicers we reviewed have devised good methods for implementing the program, although, breakdowns in the servicers process and systems can occur resulting in deficiencies. On a monthly basis, these servicers are internally reviewing the systems established to ensure compliance with policies, plans, procedures, laws, and regulations, which could have a significant impact on operations and should determine whether the organization is in compliance.

A well-designed quality control plan can identify weaknesses in the servicer's administration of the program early enough to resolve the weakness before the identified situation can become a serious problem. The Department should provide clear guidance to servicers by identifying important loss mitigation polices, plans, procedures, laws and regulations that need to be monitored on a continuous basis. This will help provide assurance to the

Department that servicers are properly implementing the program and covering the necessary compliance areas.

Post claim reviews done separately

In our 1999 audit[7], we recommended that the Department implement procedures to evaluate loss mitigation payments during post claim reviews. HUD approved a separate contract to hire a private firm to perform post claim reviews to satisfy the recommendation. This process could be augmented by incorporating post claim reviews with servicing monitoring reviews. The monitoring reviewer could follow the loss mitigation or foreclosure processes all of the way from loan default through HUD claim payment.

Current guidance is unclear, inconsistent or does not address issues identified by servicers

Mortgagee Letter 00-05 provided a framework for the loss mitigation program. However, large servicers advised that there is still confusion and a lack of guidance on a number of issues. During our reviews of the eight servicers, the servicers pointed out numerous instances whereby instructions from HUD were unclear or inconsistent. They also expressed that requests for clarifying instructions from HUD were often unclear or conflicted with other instructions. In addition, sometimes instructions and guidance voiced by HUD officials at conferences or meetings differed from written instructions the servicers had previously received from HUD.

National Servicing Center

The HUD National Servicing Center in Oklahoma City is responsible for providing prompt and decisive responses to all inquiries from the industry, Headquarters, HUD counterparts, and the public. Servicers advised that if they had a question that fell within the framework of Mortgagee Letter 00-05 the servicing center was quick to respond. However, if the question was outside of the framework of the mortgagee letters then the servicing center was less likely to provide a formal response in writing or a response at all.

Servicers are concerned because the Department will not provide a timely response to the many questions that are not answered in Mortgagee Letter 00-05. Poor communications can create distrust between HUD and some servicers.

[7] On September 30, 1999, the District Inspector General for Audit, Rocky Mountain District, issued audit report 99-DE-121-0001, Nationwide Review Department of Housing and Urban Development's Loss Mitigation Program.

Previous report identified that servicers did not document why it used one tool over another

Our previous report showed that some servicers were not documenting why they used certain home retention tools. Our current review identified that servicers improved the documentation after the issuance of Mortgagee Letter 00-05. The improvement generally consisted of better file maintenance or better comprehensive descriptions in automated systems. Although, in some instances we could not verify the servicers reason for using one option over another because they were using automated systems that would overwrite prior activities when there was a new loss mitigation occurrence; such as income and expenses, credit reports, and physical inspections.

Some servicers advised us that while HUD provided checklists and examples in the mortgage letters, they were still unsure about what HUD wanted documented or how to fully document the loss mitigation activities. Even for our review, we were unsure of what specific documentation HUD wanted to support the servicers utilization of the loss mitigation options.

Inconsistent implementation of the loss mitigation program

We discussed instances in Findings 1 and 2, where there was a lack of consistency by servicers administering the loss mitigation program. For example, in Finding 1 we described how some large servicers were using good business judgment when deciding whom to let participate in the loss mitigation program while other large servicers were letting almost every interested borrower participate in the program despite its better judgment. Also, in Finding 2 we discussed how some servicers were utilizing partial claims only when appropriate while others were overusing the loss mitigation strategy because it was quick and simple, and other strategies had complications.

An evaluation report[8] of the loss mitigation program prepared by an independent HUD contractor identified similar aspects of loss mitigation use varied greatly among servicers in the rate and type of options used. The report recommended that HUD establish better communications with servicers to clarify how to implement loss mitigation, provide feedback about how a servicer's use of the program conforms to expectations, and to disseminate information on best practices.

Due to this lack of consistency in implementing the loss mitigation tools by the different servicers, HUD is hampered to measure the overall success of the program or set benchmarks. Providing consistent improved guidance will assist in ensuring that all

[8] HUD commissioned Abt Associates to study the loss mitigation program in response to our prior audit of the loss mitigation program. Abt Associates issued its report in November 2000.

servicers are using the same basic guidelines for implementing the program. Therefore, the Department will be better able to measure the overall success of the program and set benchmarks.

The large servicers we reviewed are studying aspects of the program and have extensive experience processing loss mitigation options. We noted that some servicers are much farther on the learning curve than others. These types of servicers can provide HUD with a unique knowledge of the program, which can help HUD improve program effectiveness. HUD should establish a form of communicating best practices to servicers that have not reached the same point. This will help facilitate consistency and the overall improvement of the program.

HUD has limited assurance that the Loss Mitigation program is maximizing home retention and reducing cost to the FHA insurance fund. Servicers need additional guidance to effectively manage and monitor the program and HUD needs to increase monitoring and oversight of large servicers. HUD can increase this assurance by improving guidance and its monitoring and oversight of the loss mitigation program.

Auditee Comments

HUD generally concurred with the finding and has updated guidance on quality control plans and will issue a new revision this fiscal year. HUD also agreed to explore ways to improve targeting; review communications issues between HUD and lenders, and between divisions of FHA; and react to policy and procedural guidance problems quicker. HUD noted that there are few lender institutions where comprehensive reviews are possible because servicing and origination functions are in different geographical locations. We revised the report in response to this concern. HUD's complete response is shown in Appendix 1.

## Recommendations

We recommend that HUD:

4A. Expand monitoring and oversight of servicing operations by:

- Targeting high risk large lenders that service a majority of loans receiving loss mitigation assistance;
- Targeting high risk servicers that are only using one or two of the loss mitigation home retention tools;
- Providing specific quality control plan requirements for servicers to internally monitor loss mitigation; and

- Including post claim reviews when performing loan servicing reviews to eliminate the need for separate reviews, whenever possible.

4B. Formulate a process to establish better communications with servicers to enhance policies and procedures for implementing loss mitigation by:

- Formulating processes to provide clear written guidance to clarify issues raised by the industry;
- Disseminating information on best practice; and
- Establishing workgroups with key servicers to bring about positive change and improvements to the program.

4C. Use knowledge and data gained from monitoring reviews to formulate policy and procedural enhancements to improve the current implementation of the program.

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# Issues Needing Further Study and Consideration

**During our review, we noted additional issues that warrant HUD's consideration and possible action. HUD should: (1) consider including or capitalizing foreclosure fees in workout plans and protect borrowers from unscrupulous servicers through the quality assurance review process; (2) ensure that it is properly recording partial claim note write-offs and accurately reporting the notes receivable balance; and (3) reconsider the current requirements for reporting default status codes, as described in Mortgagee Letter 99-9, if the systems in place can't feasibly or cost effectively accommodate all of the codes.**

Foreclosure fees should be an allowable cost

When using a special forbearance, Mortgagee Letter 00-05 states:

> *"May allow reasonable foreclosure costs and late fees accrued prior to the execution of the special forbearance agreement to be included as part of the repayment schedule. However, they may only be collected **after** the loan has been reinstated through payment of all principal, interest, and escrow advances."*

When using a loan modification, it states:

> *"Foreclosure costs, late fees and other administrative expenses **may not** be capitalized. Lenders may collect the legal and administrative fees (resulting from the canceled foreclosure action), from mortgagors to the extent not reimbursed by HUD, either through a lump sum payment or through a repayment plan separate from, and subordinate to, the modification agreement."*

When using a partial claim, it states:

> *"The lender **may not** include late fees, legal fees or other administrative expenses in the partial claim note. However, lenders may collect legal and administrative fees (resulting from a canceled foreclosure action) directly from the borrower to the extent not reimbursed by HUD and in accordance with the limitations of Chapter 4 of HB 4330. 1 REV-5."*

In other words, while the servicer incurs costs and fees in connection with a delinquent or defaulted loan, the servicer is unable to collect these costs from the borrower until the loan is brought current, which may take several months or even years.

All of the large servicers we visited took exception to this policy. Their exception stemmed from two reasons. First, the servicer must finance from their business funds the costs incurred for collecting a delinquent or defaulted loan and are prevented from collecting these costs from the borrower until the borrower's loan is brought current. Second, borrowers who have brought their loan current are then faced with paying for the servicer's costs and fees for which the borrowers may be financially unable to pay. As a result, some borrowers are thrust back into delinquency because they lack sufficient monies to pay for the previously assessed costs and fees. In some cases, the borrowers allow their property to go into foreclosure or files bankruptcy.

Servicers are required to follow the procedures and timetables prescribed by HUD in working with a delinquent mortgagor. In any event, the servicer is required to initiate foreclosure proceedings on the delinquent loan within six months if the borrower is unable or unwilling to reach a workout arrangement with the servicer. The servicer incurs costs and fees in connection with processing delinquent accounts and initiating foreclosure actions. If the delinquent homeowner does decide to obtain a workout arrangement with the servicer for the delinquent mortgage, the servicer is prevented by HUD requirements from collecting the accumulated delinquency processing costs and fees from the borrower until the mortgage is brought current.

A HUD official told us that HUD does not want to see the servicers using concurrent foreclosure plans, where it is a race to either cure the loan or complete foreclosure. Nor does HUD want to see loss mitigation plans fail because the borrowers cannot come up with an up-front payment of fees that are disguised in the repayment plans. So, servicers are required to wait until the loan is reinstated to collect the costs. Consequently, plans are failing after loss mitigation workouts because borrowers are unable to pay the fees.

It is understandable that HUD is concerned that some servicers will not be exercising due diligence when processing foreclosures but there is no need to punish all servicers. HUD should consider including or capitalizing foreclosure fees in workout plans and protect borrowers from unscrupulous servicers through the quality assurance review process.

**Partial claim notes receivable balance needs to be accurately maintained and reported**

OMB Circular A-129 requires agencies to ensure that delinquent debts are written off as soon as they are determined to be uncollectible. Partial claim notes normally become uncollectible when the property is foreclosed and conveyed to HUD.

As of April 30, 2001, we identified 670 loans with partial claims whereby the properties have been conveyed to HUD, but HUD has not written off the uncollectible loans. Thus, HUD has $4,194,832 in uncollectible notes that may still be on HUD's financial books.

In January 2001, HUD's National Servicing Center instructed the contractor, who services the partial claim notes for HUD, to submit a memo and a copy of the loans to be written-off to them for approval. In June 2001, the HUD Single Family Post Insurance Division in Headquarters provided the contractor with procedures to closeout the uncollectible partial claims.

After the write-off was approved by the National Servicing Center in July, the contractor was instructed to follow the procedures it received in June to write-off 442 partial claims. Later in the month, the contractor was instructed to write-off an additional 281 partial claims; but before the process was completed they were informed by the National Servicing Center to cease the write-off process.

This change in decision was based on the fact that HUD's Office of the Assistant Chief Financial Officer for Accounting deemed the write-off could not be recorded as planned because the funds still needed to be accounted for in HUD's Single Family Acquired Asset Management System. At the time of our review, the Department has not formulated new procedures to write-off uncollectible partial claims. Therefore, HUD needs to implement an adequate process to ensure that it is properly recording partial claim note write-offs and accurately reporting the notes receivable balance.

In addition, the Audit of the Federal Housing Administration's Fiscal Year 2000 Financial Statements does not separately disclose the notes receivable balance or the associated loan loss guarantee resulting from partial claim loans. Partial claim loans are rapidly rising and the balance exceeds $100 million. Although, the account has not reach the level of reporting materiality, it may reach this level in the future. Nevertheless, separate disclosure of this account will enable users of the FHA financial statements to track the year-end note balance.

**Reconsideration needed of current default code data submission requirements**

HUD's issuance of Mortgagee Letter 99-9 helped to clarify the default activity codes to be used and reported by servicers to HUD for actions taken by the servicers under the loss mitigation program. Many large servicers report their default codes by way of an electronic data interchange process at the end of each month and report exceptions using the FHA Connection. The electronic data interchange submission allows only one default code per month to be reported to HUD.

Servicers who perform several loss mitigation actions on a loan during a month are unable to report more that one code to HUD at the end of each month. For servicers who automate their submissions to HUD and report multiple codes for a particular loan during a month, the HUD system will only receive the last code being reported. We observed during our site visits that some of the systems used by servicers did not provide a history of codes. Thus, the previously processed codes are overwritten by the last occurrence code. As a result, the HUD reporting system does not fully identify all loss mitigation actions that have occurred for a particular defaulted or delinquent loan. Therefore any analysis of these codes by HUD would be based on incomplete data.

HUD officials told us that servicers could use HUD's FHA Connection to report codes that are not transmitted in the monthly electronic submission. The FHA Connection is an Internet based system that permits servicers to transmit default activity to HUD on a case-by-case basis, among other loan processing functions. The FHA Connection was designed for small servicers who could not afford to transmit their default codes by way of the electronic data interchange. However, for servicers with thousands of FHA loans, using the FHA Connection is not a feasible solution for ensuring that all codes are submitted to HUD. Furthermore, we observed that due to automation the entry of default activity codes are overwritten by subsequent code entries. Therefore, some large servicers may not be able to easily identify all prior codes applied in a particular month.

As a result, HUD needs to evaluate what actions can be taken to facilitate the reporting and recording of all loss mitigation default codes to HUD by the servicing mortgages. In addition, this action may need to reconsider the current requirements for reporting default status codes as prescribed in Mortgagee Letter 99-9.

**Auditee Comments**

"We will review your suggestions in this section in detail, including changes to servicers' foreclosures expense recovery, delinquency reporting, and partial claim accounting procedures. However, it is important to note that FHA appropriately accounts for the loan loss guarantees associated with partial claims. Therefore, the concern about these notes having a material affect on FHA's financial statement appears to be unwarranted."

**OIG Evaluation of Auditee Comments**

It was not our intention to infer that we are concerned that the partial claim notes or the associated loan loss guarantees materially affected the FHA financial statements. The point that we were making was that partial claim notes and the associated loan loss guarantee balances are buried in the FHA financial statements. The notes balance exceeds $100 million, which should make it a material account. It would benefit users of the financial statements to have separate disclosure of partial claim notes so the year-end balance changes can be tracked from year to year. We revised the report to clarify our point.

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# Management Controls

**In planning and performing our audit, we obtained an understanding of the management controls that were relevant to our audit in order to determine our auditing procedures, not to provide assurance on the 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, directing, and controlling program operations. They include systems for measuring, reporting, and monitoring program performance.**

Relevant Management Controls

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

- Program Operations – Policies and procedures that management has implemented to reasonably ensure that the Loss Mitigation Program meets its objectives.

- Safeguarding Resources – Policies and procedures, related to the Loss Mitigation Program, that management has implemented to reasonably ensure that resources of the FHA Insurance Fund are safeguarded against waste, loss and misuse.

- Validity and Reliability of Data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable Single Family FHA data are obtained, maintained, and fairly disclosed in reports.

Assessment Procedures

We assessed all of the relevant controls identified above by

- Reviewing the law and regulations governing the loss mitigation program;
- Interviewing various HUD officials from Single Family Program offices and the National Servicing Center, and mortgage servicing officials;
- Performing on-site reviews at eight FHA-approved mortgage servicers that have implemented loss mitigation procedures and at HUD's contractor for servicing partial claim notes;
- Reviewing a select sample of FHA loan cases;
- Reviewing supporting documentation within the case files and related records;
- Assessing the selected servicers' quality control plan;
- Analyzing data and statistics relating to the selected mortgage servicers' loan portfolio, if provided; and

- Reviewing quality assurance reviews of the loss mitigation program.

Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained and maintained, and fairly disclosed in reports.

Based on our audit, we identified significant weaknesses in program operations and safeguarding resources, as follows:

- Program Operations

  HUD's management controls need to be improved to reasonably ensure that the Loss Mitigation Program meets its objectives. HUD has not adequately communicated to servicers the need to exercise good business judgment when approving candidates for loss mitigation. As a result they are delaying the foreclosure process, increasing costs to the insurance fund and subsidizing borrowers who don't pay their mortgage for extended periods of time. Further delays are caused by program requirements that extend processing timeframes. Servicers are overusing partial claims because it is simple to process, while it is difficult to process loan modifications. The overuse of partial claims significantly increases program costs. HUD's primary monitoring focus has been on loan origination. The limited number of servicing monitoring reviews done on behalf of the Department has targeted smaller servicers not using loss mitigation. As a result, the large servicers who process most of the loss mitigation claims may not have adequate monitoring and oversight.

- Safeguarding Resources

  HUD's management controls need to be improved to reasonably ensure that resources of the FHA Insurance Fund are safeguarded against waste, loss and misuse. Loss mitigation and foreclosure processing delays are increasing program costs. Servicers are overusing partial claims, which is the costliest loss mitigation home retention program tool. HUD does not have a process to collect overdue partial claim notes to repay interest free loans to borrowers from the insurance fund.

These two weaknesses are more fully described in the findings section of this report.

- Validity and Reliability of Data

  In our 1999 audit of the loss mitigation program we evaluated HUD's systems for paying loss mitigation claims and obtaining accurate and timely default status information from servicers. Since management controls over the validity and reliability of data have already been substantially reviewed, we did not spend much additional time in this area. In the areas we did review, we did not identify any material differences between information obtained from independent sources and information reported by HUD.

As described in the Follow-up on Prior Audits section of this report, one aspect of our 1999 audit report findings relating to this management control is still open.

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# Follow-up on Prior Audits

On September 30, 1999, we issued our nationwide review audit report, number 99-DE-121-0001 on HUD's Loss Mitigation Program. The audit report contained the following three findings:

1 - Improvement Needed in Review of Loss Mitigation Claims

2 - Improvement Needed of HUD's Monitoring and Oversight of Mortgagees' Use of Home Retention Loss Mitigation Tools

3 - Default Status Data Contained Within the Single Family Default Monitoring System Is Incomplete and Unreliable

The recommendations contained in these three findings have been satisfactorily closed except for one. This one open recommendation is briefly summarized below:

***Finding 3, Recommendation 3-A***

The Office of Single Family Housing is currently unable to include controls to detect illogical default codes and the improper use of default codes. These enhancements are not technically feasible with HUD's current computerized systems. HUD has stated that the Single Family Default Monitoring System was designed and built in the 70's using the technology available at that time and that to revise and redesign this system could prove to be cost prohibitive. The Department does not have the resources to update the Default Monitoring System so it is researching whether data downloaded from the Default Monitoring System to the Single Family Data Warehouse can be used to resolve the issue.

As part of our current audit, we reviewed HUD's progress to date on the closed recommendations identified in the prior report. Based on our review we are recommending that the Office of Single Family Housing take additional corrective action in the areas of quality assurance reviews, loss mitigation procedures and guidelines, and default status code requirements. These areas are discussed in the findings and other matters sections of this report.

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# Auditee Comments

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

JAN 15 2002

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MEMORANDUM FOR: Robert C. Gwin, District Inspector General for Audit, 8AGA

John C. Weicher

FROM: John C. Weicher, Assistant Secretary for Housing-Federal Housing Commissioner, H

SUBJECT: FHA's Response to the Nationwide Follow-up Audit of the Loss Mitigation Program

Thank you for the opportunity to review and comment on the draft audit report you developed as a result of your nationwide audit of FHA's Single Family Loss Mitigation Program. The report assesses the effectiveness and efficiency of this program in meeting the objectives of increasing homeownership retention and minimizing costs to the insurance funds. We are pleased to note that your report concludes that Loss Mitigation "is reducing foreclosures and keeping families in their homes." We certainly recognize that there still is room for improvement.

We believe that word is reaching all FHA-approved mortgage servicers that they are expected to use good business judgment in determining when and how FHA's loss mitigation options should be used. This is evident from the expanded use of the program, and shifts in overall use of different loss mitigation options which are consistent with market changes. For example, use of the mortgage modification option was more prevalent when market rates were declining significantly and the opportunity to restructure debt on older mortgages with higher rates was more pronounced. The recent increase in use of special forbearance and partial claims does reflect servicers' actions to shift to the most appropriate option to mitigate losses in the current environment.

Much of this improvement is attributable to the training provided by Housing's National Servicing Center (NSC). The Office of Housing makes every attempt to give consistent, timely advice and publishes clarifying Mortgagee Letters to address issues that arise. We are improving our monitoring and targeting tools, and are taking steps to improve internal communications.

Your report contains four findings with recommendations for corrective action. Please see the attachment for Housing's response to each of your recommendations. If you have any questions regarding this response, please contact Frederick C. Douglas, Jr., Deputy Assistant Secretary for Single Family Housing, at (202) 708-3175.

Attachment

Findings and HUD's Response

1. Program Effectiveness Can Be Improved by Servicers Exercising Good Judgment to Cease Delaying Foreclosure Process and by Reducing HUD's Required Loss Mitigation Timeframes

We agree that there is a need to continue emphasizing to servicers that they should evaluate each homeowner's circumstances timely, using sound business judgment. Through Mortgagee Letters and representation at industry conferences, we repeatedly stress the importance of using loss mitigation where possible to prevent foreclosure and reduce costs to the FHA insurance funds. Our primary requirement is that every borrower with an FHA-insured loan must be considered for Loss Mitigation prior to the third month of delinquency, although not all will qualify.

General requirements for qualifying for one of the home retention options include the following: the homeowner must occupy the property; provide sufficient information for a determination of eligibility; and demonstrate the ability to resume partial or full payments immediately or in the near future. Under the former Assignment Program, we required that some hardship be a principal cause of the delinquency. This requirement was dropped when we implemented the Loss Mitigation Program because it was intrusive, prone to inconsistent interpretations, and not always in the best interests of the Department. While hardship is no longer a prerequisite, it may be considered by the servicer as an extenuating circumstance when considering a mortgagor for Special Forbearance.

Since each homeowner's circumstances are unique, each mortgage servicer must determine an appropriate action based on individual circumstances. We will continue our efforts to train lenders on FHA's requirements for Loss Mitigation, encourage its use, clarify any questions arising about our policies and procedures, and resolve any real or perceived inconsistency in guidance issued by HUD.

With respect to allowing Loss Mitigation on mortgages that are 30 or 60 days delinquent, this proposal would have to be studied in depth for potential budgetary impacts, regulatory restrictions, and susceptibility to abuse.

Mortgagee Letter 01-14 dated May 23, 2001, implemented changes in timeline requirements for the use of the Loss Mitigation options and prescribed an order of consideration for the various options: special forbearance, loan modification and partial claim; followed by pre-foreclosure sale and deed-in-lieu. Special Forbearances and Loan Modifications may be utilized when three payments have been missed. A partial claim may be utilized immediately after the fourth payment is missed (a statutory requirement) if loan modification is not feasible. We do not currently grant more discretion to high-performing servicers for earlier intervention, as recommended in the report, in part, because of the system and administrative impacts required to implement this change. Absent such performance-based distinctions, policy changes apply across the board. As you noted, some lenders are using partial claims inappropriately and exclusively, so allowing more liberal use may not be a prudent change at this time.

We will carefully consider your various suggestions, and any suggestions from the mortgage servicing industry to improve our Loss Mitigation Program. We will review with Counsel your suggestions to accept the signature of one mortgagor, accompanied by a divorce decree, on borrower financial statements; to accept financial information from mortgagors either electronically or by hard copy; to require three-month trials before paying incentives for special forbearance plans; and to shorten the time homeowners have to reinstate their forbearance plan before foreclosure is initiated.

2. The Costliest Option to the Insurance Fund [Partial Claim] Is Being Overused.

A partial claim is often the best option available to a delinquent homeowner. As you noted, there are varied reasons why special forbearance may be infeasible. While special forbearance is intended to reach more borrowers by offering a wide variety of repayment levels, an increased payment is ultimately required to bring the mortgage current. It is not an appropriate option for those borrowers who do not demonstrate a future ability to meet this increased payment level.

A loan modification may not be a viable alternative in the following situations: current market rates are higher than the present mortgage rate, the mortgage was financed through bonds, the servicer cannot fund the new mortgage, or the modification would result in a higher mortgage payment than the borrower can afford.

We do not have sufficient data in HUD systems to always determine if the loss mitigation approach implemented was the appropriate choice, but we agree that servicers using the partial claim option exclusively should be reviewed by Housing's Quality Assurance staff. As mentioned above, Mortgagee Letter 01-14 prescribed the order in which the various options are to be considered. This clearer guidance, combined with improved targeting tools (discussed below in Finding Four), and lender outreach efforts, will help reduce inappropriate use of partial claims.

It is unclear from the report whether your conclusion that partial claims are the costliest option considered the long-term success of the various options (and losses when a foreclosure occurs despite loss mitigation efforts), or focused only on the initial incentive outlays. For a thorough evaluation of program effectiveness, a comprehensive view is required. My Office is analyzing the limited historic data available and is still in the process of determining actual cost effectiveness for each loss mitigation option.

 

3. HUD Needs to Develop a Process for the Collection of Delinquent Partial Claim Notes.

   We agree that our approach to collecting partial claims needs to be improved. We plan to continue to emphasize recovery efforts based on HUD's secondary mortgage. We are now in the process of devising procedures to detect pre-paid first mortgages, revising the Secretary-held servicing contract to require collection attempts on delinquent partial claim notes, and requesting funding to modify Credit Alert Interactive Voice Response System (CAIVRS) to include these delinquent notes. To address the confusion you found among title agents, we will review with Counsel the feasibility of renaming these documents and having the documents identify NSC as the recipient of payoffs. We are also reviewing options for collecting the unsecured partial claims in Texas.

4. HUD's Monitoring and Oversight of FHA Servicers' Loss Mitigation Programs Provide Limited Assurance that HUD Is Achieving Its Goals.

   As noted in your report, the majority of our monitoring resources have been devoted to reviewing loan origination. There are several reasons: more lenders are involved in originating loans than in servicing them (8,000 originators vs. several hundred servicers); "new" lenders are generally confined to loan origination; unscrupulous originators have little or no financial stake in the long-term success of a loan; and predatory practices are more prevalent in loan origination than in servicing. Further, servicing is becoming ever more consolidated, and servicers are better capitalized than originators (HUD requires servicers to have at least $1 million in net worth).

   None of these comments are intended to minimize the importance of servicing and the considerable influence it can have on FHA's bottom line. We will continue conducting on-site reviews of servicers, using HUD staff monitors. As you noted, a handful of servicers handle the majority of the FHA-insured portfolio and many of these are "best performers." Portfolio size is only one of several factors we use in targeting servicers for review. Other risk-based factors are default rates, cure rates, and loss mitigation usage and performance scores. We are continuing to improve the Neighborhood Watch system and will shortly unveil a component designed to target servicing performance. This change includes displaying servicers' distribution of loss mitigation claim types. We will continue to explore ways to improve our targeting by leveraging data in the Single Family Data Warehouse.

   Our Quality Assurance Divisions have conducted comprehensive (or joint origination and servicing) reviews. However, there are few institutions where a lender's servicing center is co-located with an origination branch.

   We acknowledge that our published guidance on quality control plans pre-dates the Loss Mitigation Program. We have updated this guidance and plan to issue it this fiscal year through a revision to the Lender Approval Handbook.

We are also reviewing communication issues between HUD and lenders, and between differing parts of FHA. We believe we can improve the speed with which patterns of problems influence policy and procedural guidance.

- Issues Needing Further Study and Clarification

  We will review your suggestions in this section in detail, including changes to servicers' foreclosures expense recovery, delinquency reporting, and partial claim accounting procedures. However, it is important to note that FHA appropriately accounts for the loan loss guarantees associated with partial claims. Therefore, the concern about these notes having a material affect on FHA's financial statement appears to be unwarranted.

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