AUDIT REPORT

FHA Case File Review – Underwriting Practices and Loan Characteristics Contributing to FHA Loan Performance

2003-SE-0001

MAY 15, 2003

OFFICE OF AUDIT, REGION 10
SEATTLE, WASHINGTON

audit report

Issue Date
May 15, 2003
Audit Case Number
2003-SE-0001

TO: John J. Coonts, Acting General Deputy Assistant Secretary for Single Family Housing, HU

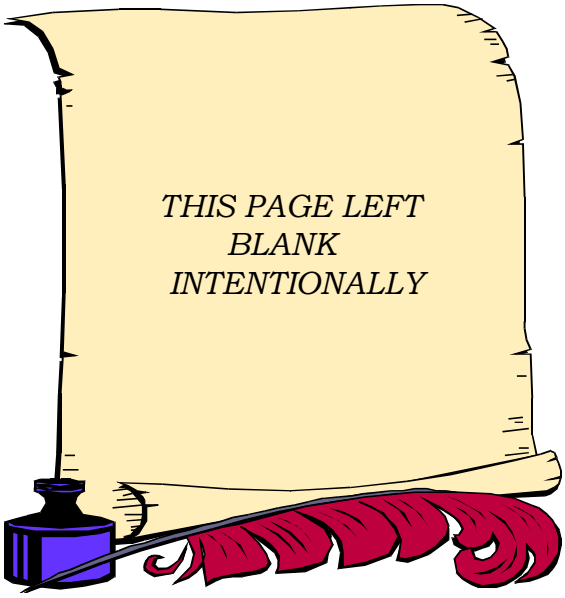
//Signed//

FROM: Frank E. Baca, Regional Inspector General for Audit, 0AGA

SUBJECT: FHA Case File Review - Underwriting Practices and Loan Characteristics Contributing to FHA Loan Performance.

We completed an audit of underwriting practices and loan characteristics contributing to FHA loan performance. The audit resulted in one finding, discussed in this report.

Should you or your staff have any questions, please call me at (206) 220-5360.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Executive Summary

Industry use of standardized credit scoring for mortgage loans, such as those provided by Fair, Issac and Co., (FICO) is widespread. However, FHA underwriting does not rely on these scores. Current restrictions on bad credit are very flexible, but are often subjective. The subjective nature of the criteria can provide deserving families the opportunity for home ownership, but it can also be overly permissive and tolerant toward borrowers with bad credit histories. Credit scores provide evaluations of risk based on an objective formula. Our observations demonstrate that lower credit scores, or loans without scores, have much poorer loan performance than other loans. Subprime lending contributes to higher mortgage insurance premiums to the detriment of homebuyers who have maintained good credit.

We reviewed a statistical sample of 1,180 FHA case files to assess underwriting practices and loan characteristics contributing to FHA loan performance. We observed a number of factors that correlate with performance, mostly those related to the credit worthiness of borrowers. By far the strongest correlation was with FICO credit scores. Of the 1,180 case files reviewed, 1,096 had credit scores and 84 had no credit scores. Although borrowers with average FICO credit scores under 620 made up only 24.7 percent of the sampled files with credit scores, they accounted for 47.1 percent of the defaults and 58 percent of the claims observed.

Loans having borrower credit scores of less than 620 and loans that had no borrower credit score made up 30.1 percent of the sample. We consider these subprime loans. Based on these results, we are 90 percent confident that subprime loans account for between 27.9 percent and 32.4 percent of the 2,840,549 single family FHA loans with beginning amortization dates from October 1, 1997 to March 31, 2001. These loans were responsible for 54.3 percent of all loans that defaulted at least once, and 65.9 percent of all claims observed in our sample. We did not have a sufficient number of default occurrences in our sample to accurately project the default rate of specific categories of loans.

HUD has taken steps toward developing the Technology Open To All Lenders (TOTAL) scorecard, an automated underwriting system that considers using credit scoring and systematic confirmation of the borrower's identity. The FHA plans to initiate the use of the TOTAL scorecard sometime in FY 2003.

We are recommending that HUD (1) collect and track the credit scores in HUD systems to permit future studies and targeting of quality assurance activities, (2) consider streamlining the origination and endorsement process, and (3) consider strengthening endorsement procedures for loans with extended delays in submission, especially loans that have no credit scores.

Other matters for consideration include developing systematic checks to verify the identity of FHA borrowers, and cleaning up contradictory fields in the SFDW.

On December 3, 2002, the OIG sent the General Deputy Assistant Secretary for Housing a discussion draft report. We discussed the findings with the Deputy Assistant Secretary for Housing and other FHA officials in an exit conference on January 22, 2003. After the exit conference the OIG revised the draft report and issued it for comment on January 24, 2003. The Deputy Assistant Secretary for Housing sent a written response to the OIG on March 28, 2003.

In the response, the Office of Housing did not dispute the information disclosed, but offered some alternative views on the conclusions in this report. Housing Officials concurred with a majority of the points in our recommendations. In response to HUD's comments, we made some modifications to the audit recommendations. A copy of the Office of Housing's full response is included as Appendix B.

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Abbreviations

APR	FICO reports national average home lending rates
DAP	Down payment assistance program
DAS	Deputy Assistant Secretary
FHA	Federal Housing Administration
FICO	Fair, Isaac and Co.
GAO	General Accounting Office
HUD	Housing and Urban Development
MCAW	Mortgage Credit Application Worksheet
OIG	Office of Inspector General
PD&R	Policy Development & Research
SFDW	Single Family Data Warehouse
SSN	Social Security Number
TOTAL	Technology Open To All Lenders

Introduction

In a March 2001 memorandum to the HUD Inspector General, the Deputy Federal Housing Commissioner requested that the Inspector General re-examine the higher default and claim rates of seller-derived down payment assistance program (DAP) mortgages. The OIG proposed using a statistical sampling methodology to review FHA case files to determine the number of single family FHA financed homes that were purchased with down payment assistance from nonprofit corporations. The sampling plan was reviewed and accepted by HUD's Office of Policy Development and Research with only a minor modification.

During the course of the DAP audit, Audit Report 2002-SE-0001, dated September 25, 2002, we noted numerous issues outside the scope of that audit concerning the quality of underwriting and the condition of the case files. We initiated this audit to address those concerns.

Audit Objectives

The overall audit objective was to review the underwriting practices and loan characteristics that correlate with loan performance. We reviewed a statistical sample of 1,180 FHA case files to identify those traits that are most commonly associated with poor loan performance.

Audit Scope and Methodology

To achieve our objectives, we:

- Conducted discussions with HUD Single Family Housing staff to obtain information on Automated Underwriting Systems, and to obtain HUD's perspective on borrower credit scores and other issues identified during our audit;
- Prepared a statistical sampling plan documenting the sampling objectives, features to be tested, description of the sampling unit and universe, sample size calculation, sample selection process, and sample evaluation method;
- Randomly selected a sample of 1,180 case files from all FHA loans used for home purchases with beginning amortization dates from October 1, 1997 to March 31, 2001;
- Obtained the FHA case files for each loan in the sample and reviewed the file documents to determine relevant characteristics of the transaction;
- Obtained and reviewed default and claim information on the sampled loans as of August 2002 from the Single Family Data Warehouse (SFDW);
- Categorized the sampled loans by characteristic and computed rates of default and claims for each category;
- Projected the rates of occurrence for significant trends to the universe from which the sample was drawn;

- Obtained and reviewed HUD Office of Policy Development & Research (PD&R) Publications related to the issues observed during the course of this audit.

This review encompassed all FHA single family loans used for home and condominium purchases with beginning amortization dates from October 1, 1997 to March 31, 2001 and did not include any FHA-insured loans used for refinancing. This amounted to 2,840,549 insured loans with a total value of approximately $280 billion. We used the EZ-Quant statistical sampling software package developed by the Defense Contract Audit Agency for this review. A description of EZ-Quant and our statistical sampling methodology is attached as Appendix A.

We obtained the FHA case files for the 1,180 FHA loans randomly selected for our sample. We reviewed the following documents from each case file:

- Uniform Residential Loan Application
- HUD-1 Settlement Statement
- Mortgage Credit Analysis Worksheet
- Insurance Application results printout
- Credit reports
- Appraisal
- Bank statements and other documentation of funding sources
- Income documentation
- Sales contracts
- Other miscellaneous documents

From these documents we were able to determine the characteristics of each loan, collect data to complete our questionnaire, and assess the risks associated with each loan.

We performed audit work in our Seattle, Washington office from December 2001 to September 2002. The audit covered FHA single family loans with beginning amortization dates from October 1, 1997 to March 31, 2001 used for house and condominium purchases. The audit was conducted in accordance with generally accepted government auditing standards.

Loans With Low or No Borrower Credit Scores Have Significantly Higher Default Rates

Industry use of standardized credit scoring for mortgage loans, such as those provided by Fair, Isaac and Co., (FICO) is widespread. However, FHA underwriting does not rely on these scores. Current restrictions on bad credit are very flexible, but are often subjective. The subjective nature of the criteria can provide deserving families the opportunity for home ownership, but it can also be overly permissive and tolerant toward borrowers with bad credit histories. Credit scores provide evaluations of risk based on an objective formula. Our observations demonstrate that lower credit scores, or loans without scores, have much poorer loan performance than other loans. Subprime lending contributes to higher mortgage insurance premiums to the detriment of homebuyers who have maintained good credit.

Of the 1,180 FHA case files in our statistical sample, 1,096 case files contained borrower credit scores. Of the 1,180 files, 30.1 percent represented "subprime" loans.[1] These subprime loans were responsible for 54.3 percent of all defaulting loans and 65.9 percent of all claims of our sampled files. Based on these results, we are 90 percent confident that FHA borrowers with subprime loans account for between 27.9 percent and 32.4 percent of the 2,840,549 single family FHA loans (a total value of approximately $280 billion) that have beginning amortization dates from October 1, 1997 through March 31, 2001.

The use of subjective criteria in accepting endorsement for subprime loans represents an increased risk to the FHA insurance fund. This is because loans with lower borrower credit scores have a greater tendency to default and result in claims than loans to borrowers with higher credit scores. The higher claims rate for FHA borrowers with low or no credit ratings increases the cost of homeownership for the more credit worthy FHA borrowers through higher mortgage insurance premiums.

Current Restrictions on Bad Credit Are Very Flexible, but Are Often Subjective

HUD Handbook 4155.1 REV-4 CHG-1 provides rules and guidance for credit approval. The rules are very flexible and are often stated in subjective terms, relying on the judgment of the underwriter to determine credit worthiness. In many situations borrowers are permitted to provide explanations to remedy noncompliant history.

The handbook defines the purpose of mortgage credit analysis in paragraph 2-1 of the Overview. The purpose is to determine the borrowers' ability and willingness to repay the mortgage debt, and thus, limit the probability of default or collection difficulties. Four major elements are typically

[1] A HUD study entitled Unequal Burden: Income and Racial Disparities in Subprime Lending in America (April 2000) states that "Subprime lending involves providing credit to borrowers with past credit problems, often at a higher cost or less favorable terms than loans available in the conventional prime market." For purposes of this report, we consider subprime loans to be loans to borrowers with credit scores of less than 620 or no credit scores.

evaluated in assessing a borrower's ability and willingness to repay the mortgage debt:

- Stability and Adequacy of Income
- Funds to Close
- Credit History
- Qualifying Ratios and Compensating Factors

This finding relates to the assessment of the borrower's credit history.

According to HUD Handbook 4155.1, SECTION 1: CREDIT HISTORY

> "2-3 ANALYZING THE BORROWERS CREDIT. Past credit performance serves as the most useful guide in determining the attitude toward credit obligations that will govern the borrower's future actions. A borrower who has made payments on previous or current obligations in a timely manner represents reduced risk. Conversely, if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong offsetting factors will be necessary to approve the loan.
>
> When analyzing the borrower's credit record, it is the overall pattern of credit behavior that must be examined rather than isolated occurrences of unsatisfactory or slow payments. A period of financial difficulty in the past does not necessarily make the risk unacceptable if a good payment record has been maintained since. When delinquent accounts are revealed, the lender must determine whether the late payments were due to a disregard for, or an inability to manage, financial obligations, or to factors beyond the control of the borrower including delayed mail or disputes with creditors."

Examples of guidance for the credit decision from the remainder of this section includes:

> ". . . major indications of derogatory credit, including judgments and collections, and any other recent credit problems, require sufficient written explanation from the borrower. The borrower's

explanation must make sense and be consistent with other credit information in the file."

". . . Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejection."

". . . Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history unless there is major derogatory credit on his or her revolving accounts."

"When reviewing the borrower's credit and credit report, the lender must pay particular attention to the following:

A. Previous rental or mortgage payment history . . . covering the most recent 12-month period.

B. Recent and/or Undisclosed debts . . . The borrower must explain all inquiries shown on the credit report.

C. Collections and Judgments . . . Both collections and judgments indicate the borrower's regard for credit obligations and must be considered in the analysis of creditworthiness.

D. Previous mortgage foreclosure . . . within the previous three years is generally not eligible for an insured mortgage. However, if the foreclosure of the borrower's principal residence was the result of extenuating circumstances beyond the borrower's control and the borrower has since established good credit, an exception may be granted . . .

E. Bankruptcy. A bankruptcy (Chapter 7 liquidation) will not disqualify the borrower if at least two years have passed . . . but not less than twelve months may be acceptable if the borrower can show that the bankruptcy was caused by extenuating circumstances . . ."

Credit Approval Process needs to be more Objective

The credit approval process lacks objective measures to guide underwriting and to provide risk assessment measures for quality assurance reviews. The criteria is somewhat

subjective in terms of what constitutes bad credit. The subjective nature of the criteria and its allowance for exceptions can provide deserving families the opportunity for home ownership, but it can also be overly permissive and tolerant toward borrowers with bad credit histories.

Credit Scores Evaluate Risk

Of the 1,180 case files reviewed, 1,096 had borrower credit scores and 84 had no credit scores. All 1,096 files with credit scores had FICO (Fair, Isaac and Co.) scores. According to the FICO website:

> "Credit bureau scores are often called 'FICO scores' because most credit bureau scores used in the US are produced from software developed by Fair, Isaac and Company. FICO scores are provided to lenders by the three major credit reporting agencies: Equifax, Experian and TransUnion."
>
> "The higher the score, the lower the risk. But no score says whether a specific individual will be a "good" or "bad" customer. And while many lenders use FICO scores to help them make lending decisions, each lender has its own strategy, including the level of risk it finds acceptable for a given credit product. There is no single "cutoff score" used by all lenders and there are many additional factors that lenders use to determine your actual interest rates."

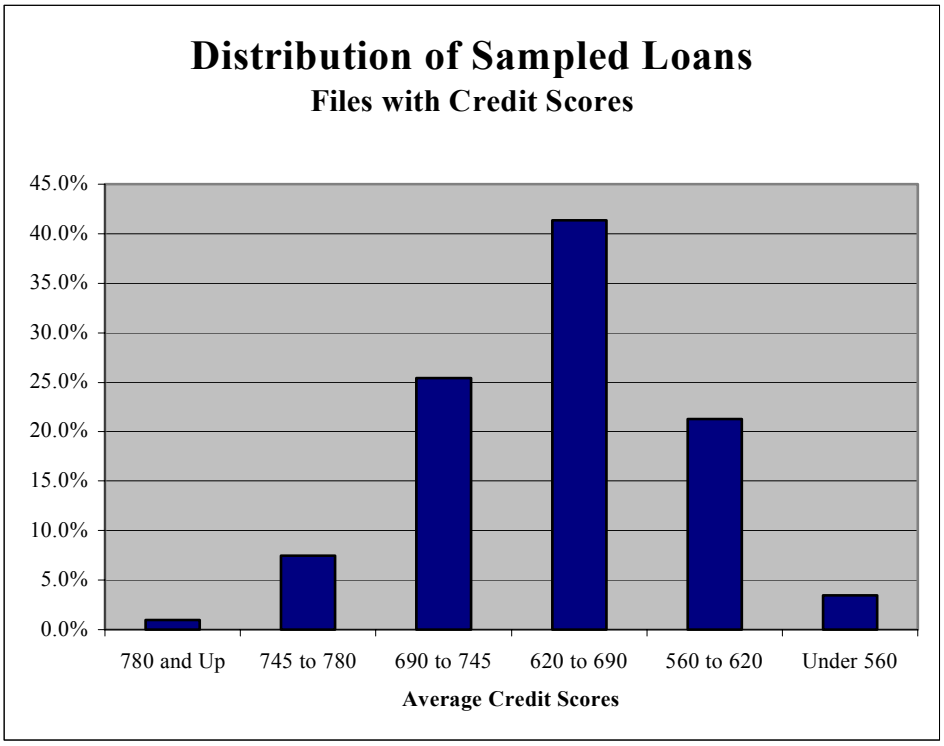
The web page also explains the common sources of FICO scores:

> "FICO scores have different names at each of the three credit reporting agencies. All of these scores, however, are developed using the same methods by Fair, Isaac, and have been rigorously tested to ensure they provide the most accurate picture of credit risk possible using credit report data."

Credit Reporting Agency	FICO Score
Equifax	Beacon®
Experian	Experian/Fair, Isaac Risk Model
TransUnion	Empirica®

The FICO website also points out that: "Lenders use the FICO score as a component in how they set the interest rate they will charge for a loan."

The median FICO score of the 1,096 (of 1,180) sampled files with credit scores was 661, with the following distribution among the various categories used by FICO.

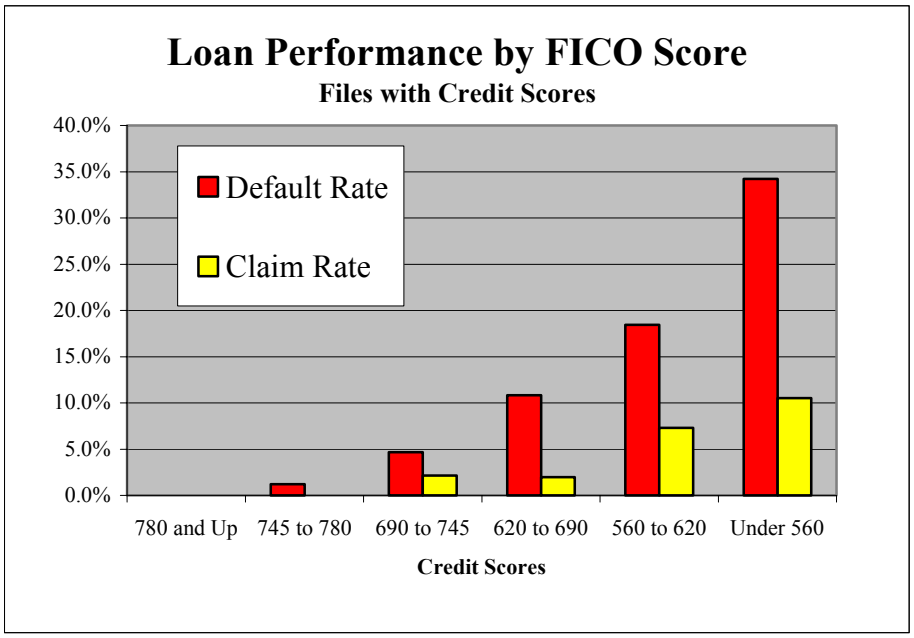


Loans With Low Borrower Credit Scores Show Significantly Worse Performance

We reviewed loan default and claim information in HUD's Single Family Data Warehouse (SFDW) for the 1,180 loans in our sample as of July 2002. When grouped by ranges of credit scores, a very clear trend develops in both default and claim rates, namely, low credit score loans have a significantly high occurrence of defaults and claims compared to loans with higher borrower credit scores:

Average Credit Scores And Performance Observed in Sampled Files

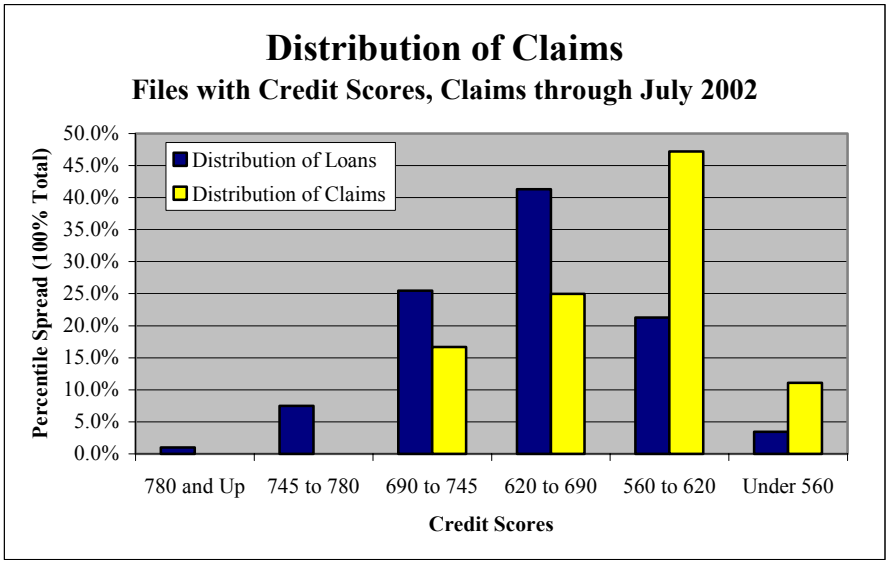
Credit Scores	Loans	Distribution	Defaults	Default Rate	Claims	Claim Rate
780 and Up	11	1.0%	-	0.0%	-	0.0%
745 to 780	82	7.5%	1	1.2%	-	0.0%
690 to 745	279	25.5%	13	4.7%	6	2.2%
620 to 690	453	41.3%	49	10.8%	9	2.0%
560 to 620	233	21.3%	43	18.5%	17	7.3%
Under 560	38	3.5%	13	34.2%	4	10.5%
Sub Total	1,096	100.0%	119	10.9%	36	3.3%



The results show only 24.7 percent of the scored files (271 of 1,096 files) had credit reports averaging under 620, yet these cases accounted for over 58 percent of all claims for the scored files (21 of 36 claims). Performance of these loans through July 2002 resulted in a default rate of 20.7 percent and a claim rate of 7.7 percent. The median credit score was 625 for the 119 defaulted loans and 608 for the 36 loans with claims, compared to 665 for the 977 non-defaulted files with credit scores.

Comparison of Files with Borrower Credit Scores Over and Under 620

Credit Scores	Loans	Distribution	Defaults	Default Rate	Claims	Claim Rate
620 and Up	825	75.3%	63	7.6%	15	1.8%
Below 620	271	24.7%	56	20.7%	21	7.7%
Grand Total	1,096	100.0%	119	10.9%	36	3.3%



Loans With No Borrower Credit Scores Also Have High Default Rates, Especially Those With Delayed Endorsements

Of the 1,180 case files reviewed, 84 files, or 7.1 percent of the sample, did not have a credit score in the file. These files accounted for 13.8 percent and 18.2 percent of all defaults and claims, respectively, in the sample. Of the 84 loans, 57 had insufficient credit to enable the credit agency to rate the borrower. Another 27 files appeared to have sufficient credit, of which 16 showed significant negative information, but no score existed in the credit report. The loans with no borrower credit scores had higher default and claim rates than even the low credit score loans. This data also supports a strong relationship between credit scores and performance. Files without scores predominantly represent borrowers with no credit or poor credit.

Comparison of Scored and Unscored Files

Credit Scores	Loans	Distribution	Defaults	Default Rate	Claims	Claim Rate
620 and Up	825	69.9%	63	7.6%	15	1.8%
Below 620	271	23.0%	56	20.7%	21	7.7%
No Score In File	84	7.1%	19	22.6%	8	9.5%
Grand Total	1,180	100.0%	138	11.7%	44	3.7%

The audit results also found an apparent correlation between some poor performing loans without borrower credit scores and loans where endorsement was delayed for over 100 days. FHA Handbook 4155.1 REV-4 allows 60 days after closing for submission of loan files before requiring additional payment documentation and certification from lenders. Thirty percent of the sample

loans (364 of the 1,180 sampled loans) were endorsed over 60 days after closing, of which 14.5 percent (171 loans) were endorsed over 100 days after closing. The default rate for these 171 loans was 14.0 percent compared to 11.3 percent for the other sampled loans, but the higher default rate was almost completely due to the 47.1 percent default rate for 17 of the loans that did not have borrower credit scores.[2]

Loans With No Borrower Credit Scores and Delayed Endorsements

Days from Closing to Endorsement	Loan Had Credit Score?	Number of Loans	Defaults	Default Rate	Claims	Claims Rate
Over 100 days	**No**	**17**	**8**	**47.1%**	3	**17.6%**
	Yes	154	16	10.4%	6	3.9%
Total over 100 days		171	24	14.0%	9	5.3%
Under 100 days	**No**	**67**	**11**	**16.4%**	**5**	**7.5%**
	Yes	942	103	10.9%	30	3.2%
Total under 100 days		1,009	114	11.3%	35	3.5%
Total all loans		**1,180**	**138**	**11.7%**	**44**	**3.7%**

Combining the results for loans with borrower credit scores under 620 and no credit score in the file provides a good indication of the magnitude of high risk (subprime) loans. Of the 1,180 case files reviewed, 355 files (30.1 percent of the sample) were subprime loans with either borrower credit scores below 620 or no score at all. Although only 30.1 percent of the files fall into this category, they resulted in 65.9 percent of all claims for the sampled files (29 of 44 claims). Performance of these loans through July 2002 resulted in a default rate of 21.1 percent and a claim rate of 8.2 percent.

Potential Subprime Loans

Credit Scores	Loans	Distribution	Defaults	Default Rate	Claims	Claim Rate
Below 620	271	76.3%	56	20.7%	21	7.7%
No Score In File	84	23.7%	19	22.6%	8	9.5%
Subprime Loans	355	100.0%	75	21.1%	29	8.2%

[2] A recent OIG audit report (no. 2003-KC-1001, dated October 2, 2002) found that Cendant Mortgage Company did not have adequate procedures to ensure its employees followed HUD requirements regarding the submission of loans for endorsement. The report disclosed that 1,309 of 22,108 loans were submitted to HUD more than 60 days after closing even though the borrowers had delinquent payments prior to submission.

Conclusions

Since the credit approval guidance does not always provide objective measures for when additional information or explanation is required, relying on the underwriter's judgment can permit inconsistencies in application of the standards. Our analysis of the sampled loans clearly shows that loans with poor or no borrower credit scores are poor performers in comparison to loans with higher borrower credit scores. Also, there appears to be some correlation between some loans with no borrow credit scores and the delays in endorsing those loans.

Using credit scores as part of the credit approval process provides some objectivity to the process. Underwriting loans for borrowers with poor credit puts the FHA insurance fund at a greater risk and may result in higher mortgage insurance premiums to the detriment of homebuyers who have worked to maintain good credit.

Auditee Comments

In FHA's response, the Deputy Assistant Secretary (DAS) for Single Family Housing expressed concern, stating that the "OIG's recommendations run counter to FHA's mission of providing homeownership opportunities for the underserved segment of the marketplace. FHA's current strong financial position indicates that this departure from current policy is not necessary for the fiscal solvency of the MMI fund."

The response also noted that the FHA only began receiving FICO scores in volume since 2001. It was too early to determine what role FICO scores will play in the underwriting process until a comparison can be made between the performance of loans with and without FICO scores from the same cohort. The response claimed that credit bureau scores are not the only relevant measure of a borrower's likelihood of repaying a mortgage. The mortgage industry has developed mortgage scorecards based upon consumer repayment history with other factors specific to the payment of mortgage debt.

Based on the FHA's comments, we deleted one of the recommendations, and revised two other recommendations.

In response to the first recommendation, the DAS advised that the FHA was in the process of obtaining funding to modify its data systems to collect credit bureau scores. The DAS stated that the FHA is already planning to use loan performance history as part of the implementation of its TOTAL scorecard, but will continue to allow manual underwriting of cases rejected by the TOTAL scorecard system. The response further noted that the FHA is concerned that the OIG's recommendation to use loan performance history to develop policy on acceptable credit scores for electronic underwriting limits its ability to serve first-time homebuyers. The FHA agreed to use the additional data from the implementation of the TOTAL system to enhance its monitoring reviews.

In response to the second recommendation of this report, the DAS advised that the FHA has already considered and instituted an endorsement streamlining process.

The FHA concurred with the last recommendation and will conduct a systematic analysis of the relationship between loan performance and the elapsed time between closing and endorsement. The FHA plans on using the results of this study to determine the merits of strengthening endorsement procedures.

OIG Evaluation of Auditee Comments

FHA's concern that our recommendations run counter to its mission implies that the OIG proposes new restrictions and barriers to obtain FHA financing by borrowers with impaired or no credit. However, as discussed in the finding, our concern is that the credit approval process lacks objective measures to guide underwriting, and gives lenders great leeway in approving loans . . . loans in which the entire risk is borne by the FHA, not the lenders.

It is not our intent to impede FHA from allowing lenders to make loans to low-income, minority, first-time homebuyers, or other underserved segments of the marketplace. Rather, in our opinion the FHA and lenders should make a distinction between deserving families and non-creditworthy borrowers who have a clear history of credit and other financial problems. Our review of defaulted loan files disclosed

numerous instances where lenders approved highly questionable loan applications. For example, documents in one loan file showed the borrower had many late payments, ten collections, two judgments, no assets other than an insurance settlement, and the payments on the credit report exceeded the amount shown on the Mortgage Credit Analysis Worksheet (MCAW) prepared by the loan originator. Another case file showed the borrower had a state tax lien, a collection, and a bankruptcy, and the borrower's monthly income was $800 less on the Verification of Employment than on the loan application.

There is still no firm implementation date for FHA's proposed TOTAL scorecard. When implemented, the TOTAL scorecard should satisfy Recommendation 1A. According to the FHA's Developer's Guide for the TOTAL scorecard, the scorecard will use borrower's credit scores, including FICO scores, and thus provide new data for evaluating loan performance and risk.

We support the FHA's efforts to improve the underwriting process, and encourage the FHA to undertake additional studies as it obtains more data on the FICO scores of FHA insured borrowers. The results of these studies should allow the FHA to more effectively monitor loan originations by direct endorsement lenders.

Recommendations

We recommend you:

1A. Collect FICO credit scores in the underwriting process. Use loan performance history to target quality assurance activities.

1B. Consider streamlining the origination and endorsement process.

1C. Consider strengthening endorsement procedures for loans with extended delays in submission, especially loans that have no credit scores.

Status of Recommendations	Based on the completed and proposed actions outlined in the Office of Housing's response to the draft report, management is taking sufficient action to satisfy the recommendations and no additional response to this finding is necessary.

Management Controls

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

Relevant Management Controls

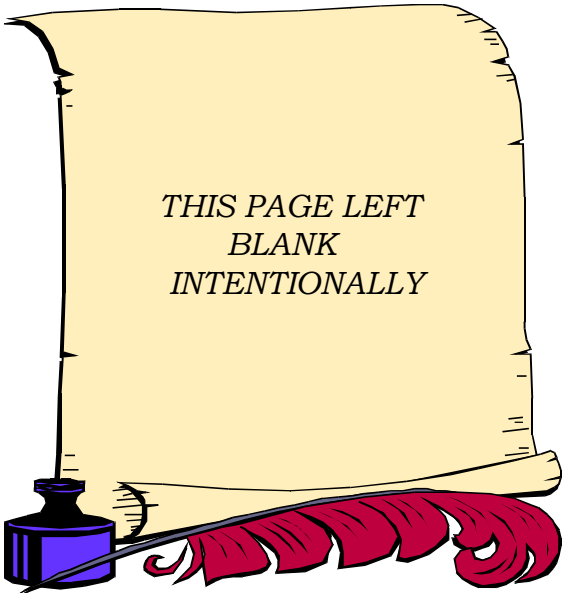
We determined the following management controls were relevant to our audit objectives:

- Underwriting of single family loans.
- Endorsement of single family loans.
- Reporting and documentation requirements for lenders.

We assessed all of the relevant controls identified above. It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations, will meet an organization's objectives.

We identified the following significant weaknesses in HUD's management controls:

- Lenders can obtain approval for FHA insurance for borrowers with poor credit histories due to subjective and permissive criteria.
- Lender delays in obtaining endorsement for FHA insurance does not trigger additional monitoring.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Issues Needing Further Study and Consideration

Although not a part of our audit objectives, our review of FHA case files disclosed two issues that warrant further consideration by HUD officials.

Incorrect Social Security Numbers Are Not Detected

A review of 1,180 randomly selected FHA case files found that FHA cannot always positively identify borrowers based on information in their systems because it does not have a reliable means of confirming the identity of borrowers prior to endorsement. FHA relies upon underwriters to confirm the borrower's identify with inconsistent results. Our audit observed that it is possible for borrowers to acquire FHA financing using inaccurate Social Security Numbers (SSN).

Our review of 1,180 FHA loan files disclosed 39 loans (3.3 percent of sampled loans) that had SSN errors, in most cases resulting in incorrect SSN numbers being input into the SFDW.

Nature of Social Security Number Error	no. cases
Clerical input errors, such as number transpositions, that did not affect SFDW	10
Clerical input errors, such as number transpositions, resulting in incorrect SFDW SSN data	16
SSN errors on forms, resulting in wrong SSN input into SFDW	5
Combination of both input errors and errors on forms	3
Two different SSN numbers on different loan documents and SFDW	3
Borrower apparently used the SSN of a deceased individual	1
Lender used wrong SSN and obtained the credit report of a different individual	1
	39

Our tests were not designed to identify incorrect SSNs that were used consistently by the borrowers. Without positive confirmation of SSN records we cannot be assured that more errors do not exist beyond the 39 identified. Credit Bureaus rely on information reported to them by lenders and other third parties. They cannot provide positive confirmation of SSNs, but can only identify multiple users or inconsistent uses of SSNs as reported to them by third parties.

As a result, FHA does not always know the true identity of its borrowers, and insurance may be provided to unqualified individuals. Also, a misidentified borrower may avoid accountability for a poor payment history if it is not properly reported to credit agencies and FHA.

Information in the Files Sometimes Contradicts Data in the SFDW

A review of 1,180 randomly selected FHA case files found the following instances where data in the SFDW contradicts information observed in the case file:

- Price including closing costs (prc_excl_clsng_amt) - This field represents the price only and does not include closing costs. It appears to be an obsolete field that should be purged to prevent misinterpretations and errors.

- Closing costs (tot_clsng_csts) - The source of closing costs is the Mortgage Credit Application Worksheet (MCAW), which estimates closing costs. The data from the MCAW should be labeled as an estimate to prevent misinterpretations and errors.

- Appraisal date (apprsl_cmpltn_dt) - Many entries are only a few days off and corresponded to either the signature date or the effective date of the appraisal. Some vary by greater amounts and need individual analysis to determine the cause.

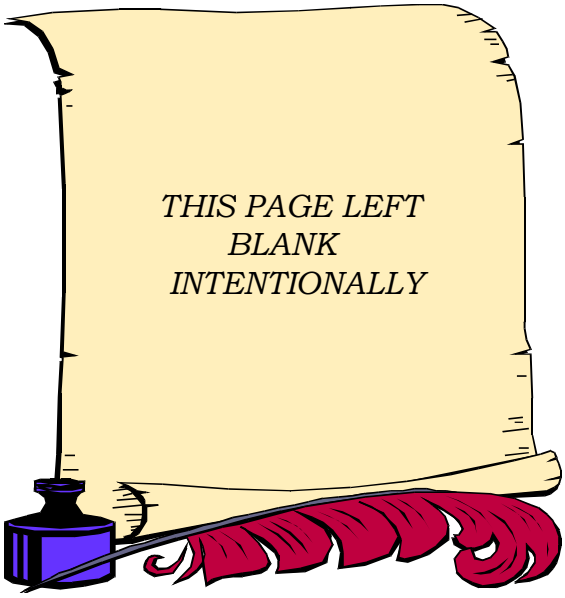
- Fixed mortgage payment (mort_pymt_fix_pi) - In many instances, the file does not document the final fixed mortgage payment. Some vary by more than a nominal amount and would need individual analysis to determine the cause.

It appears some of these situations occur due to misinterpretations, errors at data entry, and fields that are not clearly defined or described. As a result, some users of the SFDW may rely on these fields to their detriment. Improvements could be made to increase the usefulness of the information and make it easier for new users to access the data. Potential areas for improvement include clarifying requirements for data entry, reviewing computed fields for errors, removing unused fields, and identifying estimates so that users do not rely on amounts as actuals.

Statistical Sampling Methodology

EZ-Quant performs statistical sampling calculations for attribute sampling and can use the results from the review of a sample to project rates of occurrence of specific attributes to the universe from which the sample was drawn. Using EZ-Quant, we were able to review a reasonably small number of FHA case files and project the percentage of FHA loans having specific characteristics with a high degree of accuracy to our entire universe of 2,840,549 loans. With the EZ-Quant software, we calculated that a sample of 1,180 loans needed to be reviewed. We calculated the sample for a 90 percent confidence level and based it on our preliminary test results, which estimated that 10 percent of the FHA loans in our universe have defaulted. We set the maximum precision range at 3 percent for the sample size calculation.

The sample was selected at random without bias. We downloaded information from the SFDW for the 2,840,549 loans in our universe and listed the loans in the same order as they appear in the SFDW. We then assigned a sequential number to each loan as it appeared in the data beginning with 1 and ending with 2,840,549. Using the random number generator feature in the EZ-Quant software package, we generated 1,300 random numbers between a range of 1 and 2,840,549. We used the numbers selected to draw our sample of FHA loans. We used 1,300 numbers to provide replacements in the event that HUD could not locate any of the first 1,180 files in the sample. We obtained and reviewed the FHA case files for the loans selected in our random sample.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U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

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OFFICE OF THE ASSISTANT SECRETARY
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MAR 2 8 2003

MEMORANDUM FOR: Frank E. Baca, District Inspector General for Audit, 0AGA

FROM: John J. Coonts, Acting Deputy Assistant Secretary
for Single Family Housing, HS

SUBJECT: Draft audit report
FHA Case File Review – Underwriting Practices and
Loan Characteristics Contributing to FHA Loan Performance

In response to your January 24, 2003, memorandum regarding the effect of credit bureau scores on mortgage performance, I appreciate your efforts to help FHA better manage the risks associated with our mortgage insurance programs. However, I am concerned that OIG's recommendations run counter to FHA's mission of providing homeownership opportunities for the underserved segment of the marketplace.

Your office appears to be proposing that borrowers who have yet to establish a credit history and those with impaired credit, including immigrants and younger families buying their first home, either should be charged additional fees for using FHA or should be relegated to the substantially higher cost subprime market. FHA's current strong financial position indicates that this departure from current policy is not necessary for the fiscal solvency of the MMI Fund. It is also contrary to the President's stated goal of expanding homeownership opportunities, especially among minorities.

While our primary concerns focus on the overarching policy recommendations, we also question some aspects of the methodology of the audit. The broad generalizations and conclusions reached by OIG are based on a small sampling of mortgage loan case files in some cases. We believe that a detailed analysis, based on a larger random statistical sample, is necessary to provide an adequate basis for significant changes to FHA's credit policies. We note, for example, that the sample of loans without FICO scores is small (84). The standard error of estimate for a sample of 84 is about 3.1 percent for point estimates such as those reported. This is not statistically different from the point estimates for other categories. A further important consideration is that FHA began getting FICO scores in substantial volume in 2001. Consequently, it is too early to judge exactly what role FICO scores will ultimately play in the underwriting process until we can observe the performance of loans with and without FICO scores from the same cohort. We do not believe that policy changes are warranted without more extensive analysis, which we will certainly undertake as further data become available.

FHA is continually alert to its obligation to promote homeownership while properly managing and pricing the risks that it assumes. For example, FHA made several changes to its underwriting guidelines in FY 1995 in order to promote increased homeownership opportunities among low-income and minority homebuyers. By doing so, FHA modestly increased the risk characteristics of its post-1995 books of business, but it succeeded in raising FHA's proportion of first-time homebuyers from 65.4 percent in 1994 to 78.0 percent for FY 2002, and in raising its share of minority homebuyers from 25.3 percent to 36.0 percent in the same time period. FY 1995 was also the first year in which FHA exceeded the 2.0 percent capital ratio mandated by the National Affordable Housing Act of 1990. Since then, FHA's capital ratio has continued to increase. It reached 3.75 percent at the end of FY 2001 and increased substantially to 4.52 percent through FY 2002, as reported in the annual actuarial study released last month. These figures suggest that FHA has been successful in its mission of opening homeownership opportunities for underserved groups, while continuing to operate on an actuarially sound basis, as mandated by Congress. The approach of knowingly accepting a greater level of risk to achieve an important policy goal is consistent with FHA's fundamental mission.

There is a negative correlation between FICO scores and default and claim rates, as your draft report states. FHA's new business since 1995, however, continues to generate negative credit subsidy, as evidenced by the independent annual actuarial review for FY 2002, previously mentioned.

FHA is indeed mindful of the risk that borrowers who have demonstrated unwillingness or an inability to handle credit may pose to the insurance funds. We are concerned, however, that your recommendations would lead FHA to abandon a significant number of potential homebuyers that indeed *will* make their payments. While FHA continues to explore tools that will help to better discern credit risk and limit FHA mortgage insurance to those most likely to repay their mortgages, those tools are far from perfect.

Credit bureau scores are not the only relevant measures of a mortgage borrower's likelihood of repaying a mortgage. Instead of relying solely on FICO scores, the mortgage industry has developed mortgage scorecards, which combine consumer debt repayment history with other risk factors specific to mortgage debt repayment. These mortgage scorecards clearly demonstrate that low credit bureau scores can be mitigated when an applicant scores well on other risk factors such as loan-to-value ratio, debt-to-income ratio, or cash reserves. Strong independent evidence of the need for more sophisticated underwriting criteria is provided by the fact that Fannie Mae, the largest purchaser of single-family mortgages, no longer uses commercially-available credit bureau scores in its automated underwriting system, Desktop Underwriter, but has instead developed its own proxy for a credit bureau score using credit variables reported by the credit repositories. Solely relying on credit bureau scores, which are proprietary algorithms, would in all likelihood leave a large number of good borrowers behind.

A relevant recent report by the Consumer Federation of America (CFA) and the National Credit Reporting Association (NCRA) states that an "analysis of the scores in 502,623 merged credit files reveals that 29 percent of these consumers had scores with a range of at least 50 points, while four percent of the consumers had score ranges of at least 100 points. The average range of the three scores was 41 points, and the median range was 35 points." While FHA

believes that credit bureau scores are useful in predicting the risk of default on a mortgage, it also recognizes the imprecision in credit reporting and the attendant range of credit bureau scores for individuals that may affect studies such as yours.

Your memorandum also states that regarding automated underwriting, FHA has "no plan for implementation at this time." In fact, FHA expects to implement its TOTAL mortgage scorecard during FY 2003, including the establishment of policies for lenders to follow in its use. Although the TOTAL mortgage scores will be the best available objective measure of risk for FHA mortgages, FHA will instruct lenders not to reject any application on the basis of a low TOTAL score. Such cases will instead be referred for manual underwriting using current FHA guidelines. Without this manual review policy, younger first-time borrowers, many of them creditworthy minorities or recent immigrants who have yet to establish traditional credit histories, could be denied access to homeownership or relegated to the substantially higher cost subprime market. A rigid approach to mortgage credit analysis is fundamentally inconsistent with FHA's mission and the President's commitment to expanding minority homeownership opportunities.

Recommendations

1A. Collect FICO credit scores in the underwriting process. Use loan performance history to develop policy on acceptable credit scores for electronic underwriting and to target quality assurance activities.

The recommendation listed above contains three sub-recommendations. FHA's response to each is listed below:

OIG Recommendation: Collect FICO credit scores in the underwriting process.

FHA's Response: FHA concurs with this sub-recommendation. FHA already requires credit reports for all purchase money mortgages and all but certain streamline refinance transactions. FHA has OMB approval to collect credit bureau scores. FHA will request funding to modify its data systems to collect and maintain this information. After the systems have been modified, FHA will instruct mortgagees to provide this information as data fields in CHUMS.

OIG Recommendation: Use loan performance history to develop policy on acceptable credit scores for electronic underwriting.

FHA's Response: FHA nonconcurs with this sub-recommendation, because FHA is already planning to use loan performance history as part of the TOTAL scorecard, but is not requiring all lenders to underwrite loans electronically, and in fact is requiring lenders who use TOTAL or automated underwriting systems to manually underwrite loans which are rejected by TOTAL or the system. FHA also is concerned that this sub-recommendation unnecessarily limits our ability to serve first-time homebuyers. Since 1934, FHA has played an essential role in expanding homeownership opportunities for Americans. FHA has allowed lenders to make loans to millions of borrowers who would

not qualify for conventional loans. An FHA goal in using and supporting automated underwriting technologies is not to exclude underserved markets, but to better serve traditionally underserved borrowers. The technology is designed to make the underwriting process more efficient so that lenders can spend more time manually underwriting more difficult cases. FHA provides mortgage insurance for hundreds of thousands of purchase money mortgages each year and plays an essential role in providing access to homeownership for first-time homebuyers, African-American and Hispanic borrowers, and residents of underserved areas.

OIG Recommendation: Use loan performance history to target quality assurance activities.

FHA concurs with this sub-recommendation. Currently, FHA targets appraisal reviews, post technical reviews and lender monitoring reviews on loan performance histories. It is FHA's intention to use the additional data from the implementation of TOTAL to enhance these reviews.

1B. Increase oversight for borrowers with low and no credit scores by increasing quality assurance over manual credit approvals.

FHA's Response: FHA non-concurs with this recommendation. In accord with past GAO audit findings and recommendations, FHA targets its quality assurance reviews on risk based factors by lender, including early default and claim rates and types of loan originated. Predatory lending practices and fraud can occur in loans processed through automated systems as well as those underwritten manually. Consequently, FHA adapts its quality assurance activities to effectively manage its portfolio. FHA will, however, monitor the performance of manually underwritten loans as the TOTAL scorecard comes into use.

1C. Consider streamlining the origination and endorsement process and providing financial incentives to borrowers with high credit scores.

OIG's recommendation listed above contains two sub-recommendations. FHA's response to each is listed below:

OIG Recommendation: Consider streamlining the origination and endorsement process

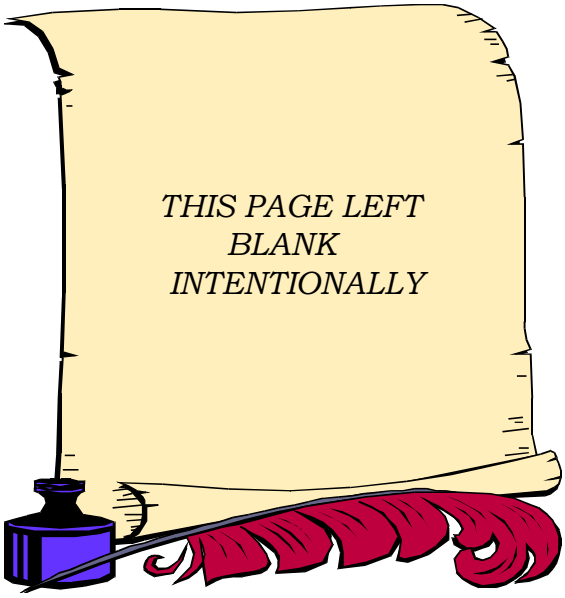
FHA's Response: FHA has completed this recommendation in that we have been considering how to streamline the origination and endorsement process, and has in fact begun the streamlining process. FHA undertook a Business Process Reengineering Project (BPR) to modernize loan origination processes involved in delivering single-family mortgage insurance. The overall goal of the BPR was to expand options to improve FHA's risk management strategy, automate paper-intensive processes, and modernize program operations. The BPR was completed in May 2002. The findings of the study are being used to further improve program operations.

OIG Recommendation: Consider financial incentives to borrowers with high credit scores

FHA Response: FHA non-concurs with this sub-recommendation. FHA is able to operate on an actuarially sound basis, and indeed add to its reserves, under current policy. Moreover, by providing financial incentives to those borrowers with high credit scores, the Department would be trading on its unique government status – its ability to commit the full faith and credit of the government of the United States - to become more competitive to private mortgage insurers and others in an effort to attract more business in what would typically be designated as a middle income market, appropriately served by the private sector.

1D. *Consider strengthening endorsement procedures for loans with extended delays in submission, especially loans that have no credit scores.*

FHA's Response: FHA concurs with this recommendation. FHA will conduct a systematic analysis of the relationship between loan performance and the lapsed time between closing and endorsement. The results of this analysis will be used in considering the merits of strengthening endorsement procedures.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