AUDIT REPORT

Title I Loan Debt Collection
Asset Recovery Division
Albany, New York

2005-NY-0001

May 18, 2005

OFFICE OF AUDIT
New York/New Jersey Region

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TO: Lester West, Director, Financial Operations Center, Office of Financial Services, 2BHFJ

Edgar Moore

FROM: Edgar Moore, Regional Inspector General for Audit, 2AGA

SUBJECT: Title I Loan Debt Collection
Asset Recovery Division, Financial Operations Center, Albany, New York

HIGHLIGHTS

What We Audited and Why

In accordance with the Office of Inspector General's (OIG) audit plan to evaluate the U.S. Department of Housing and Urban Development's (HUD) execution of its fiscal responsibilities, we conducted a survey of HUD's Title I loan claims collection activity. The Asset Recovery Division of HUD's Financial Operations Center (Center) in Albany, New York, administers this activity. Our objectives were to determine whether the Center was administering its Title I debt collection activities (1) in compliance with applicable laws and regulations and (2) in an effective manner to provide optimal benefit to the department.

What We Found

While the Center was generally complying with applicable laws and regulations, there were weaknesses in the Center's controls over Title I debt collections. Specifically, (1) significant amounts of payments are received at the Center instead of at the established lock box or via electronic funds transfer; (2) adequate controls have not been established over the receipt, recording, and processing of collections at the Center, and (3) procedures for processing debt payments have not been updated. These deficiencies occurred because the Center's management reporting system did not capture the total volume of debt payments received and processed at the Center.

What We Recommend

We recommend that the director of the Center establish and implement controls and procedures to ensure that

- Debtor payments are submitted directly to the lock box or are made via electronic funds transfer.
- All incoming mail containing debt payments is opened at a single location within the Center and in the presence of two individuals.
- All payments received at the Center are properly recorded and reconciled to the lock box receipts.

In addition, the director of the Center should implement appropriate action to have HUD Handbook 4740.2, “Title I and Other Debt Collection Guidance,” updated to reflect the most recent changes to the debt collection procedures.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee’s Response

HUD agrees with the recommendations, and has already implemented, or plans to take, corrective action to address all of our recommendations. We have adjusted the report to acknowledge those actions already taken by HUD in response to the recommendations in the draft report.

The complete text of the auditee’s response, can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVES

Title I, section 2, of the National Housing Act (12 U.S.C. 1703) authorized the Title I loan program. Under the Title I loan program, approved lenders make loans to eligible borrowers, and the Federal Housing Administration insures the lender against loss if the borrower defaults. Title I loans may be used to finance permanent property improvements that protect or improve the basic livability or utility of manufactured homes, single-family and multifamily homes, and nonresidential structures or to preserve historic homes. Private lenders are insured for losses up to 90 percent of a single loan with a limit of 10 percent of a lender's Title I portfolio. The maximum loan term is 25 years.

Nationwide Title I debt collection activity is consolidated at the Financial Operations Center's (Center) Asset Recovery Division in Albany, New York. This division also handles other types of Federal Housing Administration debts. It currently services the following types of debt:

- Defaulted Title I property improvement loans.
- Postrepossession defaulted Title I manufactured home loans.
- Single family deficiency judgments.
- Single family - miscellaneous unsecured.
- One-time mortgage insurance premium - erroneous refunds.

When the U.S. Department of Housing and Urban Development (HUD) pays a claim to a Title I lender, the related note and/or mortgage is assigned to the Center. The process of recording a paid claim and transferring the debt to the Center is fully automated through computer systems maintained by the Cash Management Branch in Washington, DC. When a claim is paid, it is recorded in the Debt Collection and Management System, after which the Center initiates collection activities.

At the Center, each debt is assigned to a debt service representative, who assesses the debtors' financial condition and ability to repay the loan, arranges debt compromises and payment plans, and monitors the collection of the debt. Within 15 days of assignment of the debt, a demand letter and credit bureau warning are issued. The debtor is given 60 days to respond. When the debtor responds, the debt service representative updates the Collections System to indicate whether the debtor has agreed to a debt compromise, payment in full, or a payment plan.

The Center's internal controls require three levels of approval before a debt can be compromised. The debt service representative assigned to the case can initiate the compromise, and both the team chief and the division chief must approve.

Billing notices, instructing debtors to submit payments to an established lock box account unless an electronic funds transfer payment arrangement has been made, are automatically generated from the Collections System and mailed to debtors by a contractor. Payments are not intended to be received at the Center. Payments collected through the lock box account are deposited and credited to debtors' accounts in the Collections System by the lock box bank. Then HUD's Cash Management Branch verifies lock box deposits to ensure that debtors' accounts were properly credited in the Collections System.

If the debtor takes no action within 75 days, a notice of intent to offset[1] is issued. The debtor has 65 days after issuance of the notice to appeal to the HUD Board of Contract Appeals for a hearing by a federal administrative law judge. If the debtor takes no action after 180 days, the debt is forwarded to the U.S. Department of the Treasury, which makes additional routine debt collection servicing efforts.

Center data as of September 30, 2004, disclosed that the Center was administering a portfolio of approximately 32,000 active Title I debt cases with a value of about $418 million. During fiscal year 2004, Title I debt collections through U.S. Department of the Treasury offset and Center efforts totaled about $33 million. Of this amount, the U.S. Department of the Treasury collected about $18.5 million, while Center action resulted in the collection of approximately $14.5 million. Of the $14.5 million collected by the Center, approximately $7.2 million, or 50 percent, represented checks received and processed directly at the Center.

[1] Offset procedures allow the government to deduct from federal payments, such as federal salary or tax refunds, amounts owed on the debt.

RESULTS OF AUDIT

Finding 1: Weaknesses Exist in Controls over Title I Program Collections

While the Center was generally complying with applicable laws and regulations, there were weaknesses in the controls over Title I debt collections. Specifically, (1) significant amounts of payments are received at the Center instead of at the established lock box or via electronic funds transfer; (2) adequate controls have not been established over the receipt, recording, and processing of collections at the Center, and (3) procedures for processing debt payments have not been updated. Consequently, the Center lacks assurance that collections are adequately safeguarded against loss or misuse. These deficiencies occurred because management was unaware of the significant level of debt payment activity processed at the Center. The Center's management reporting system captured only a portion of the total volume of debt payments received in the mail room.

Significant Receipts Received Directly at the Center

Center management was unaware of the volume of collections received directly at the Center. Center staff initially advised us that except for a few payments sent to the Center in error, Title I debt collections are processed through a direct lock box, electronic funds arrangements, or U.S. Department of the Treasury offset procedures. However, based upon Center data, the Center has been receiving significant amounts of collections directly. The receipt of payments at the Center creates unnecessary processing and recording activity for the Center and raises the potential for loss of funds. The table below illustrates that more than 50 percent of collections were made at the Center.

Fiscal year	Total collections (millions)	Collections received directly (millions)	Collections via lock box or electronic funds (millions)
2003	$ 15.9	$ 8.0	$ 7.9
2004	$ 14.5	$ 7.2	$ 7.3

HUD Handbook 1911.1, "Handling and Protecting Cash and Other Negotiable Instruments," chapter 2, paragraph 2-1(a), provides that to the extent possible, collections should be processed by wire transfer to the U.S. Department of the Treasury or by a U.S. Department of the Treasury lock box bank. Center procedures require that when a payment plan is established, a payment voucher addressed to the established lock box is forwarded to the debtor.

The Center could do more to encourage adherence to these procedures. If a debtor sends a payment to the Center, the debtor is advised to send future payments to the lock box. However, this advice is only sent once, and there is no other effort to reduce the number of debt payments sent to the Center. Many debtors sent their payments directly to the Center because they preferred using overnight mail delivery, which had not been accepted at the lock box. Accordingly, in response to our concerns, on April 1, 2005, Center officials revised their form letter and instructions for submitting payments to provide debtors an alternative lock box address, which will accept private overnight services.

Electronic funds transfers were not always used when applicable. The Center had received checks from both the U.S. Department of the Treasury and the U.S. Postal Service representing employee payroll offset arrangements. These payments are routinely received at the Center. However, 31 CFR (*Code of Federal Regulations*) 206.4(a), "Management of Federal Agency Receipts and Disbursements, Collection, and Payment Mechanisms," provides that all funds are to be collected and disbursed by electronic funds transfer when cost effective, practicable, and consistent with current statutory authority.

Collection Weaknesses Were Identified.

The Center uses a contractor to operate its mailroom. All mail is inspected in the mailroom, opened, and distributed to the appropriate Center staff. However, if mail is believed to contain a check or other form of payment, it is distributed unopened to the Center's assistant collections officer without being logged in. If mail containing a check is inadvertently opened in the mailroom, it is logged, and the payment and log are delivered to the assistant collections officer. After reviewing the opened and unopened mail received, the assistant collections officer records and processes any negotiable instruments, prepares deposit documentation, and forwards deposits to the established lock box. Consequently, mail that includes payments is opened at multiple locations without being in full view of other employees.

These weaknesses in the opening and recording of incoming receipts raise the potential that assets are not adequately safeguarded against loss or misuse. Some of the receipts we observed illustrate this increased potential risk of loss or misuse. For instance, our review of 143 collections during May 2004 disclosed checks with the following payee:

- "US Department of Housing and Urban Development (and the name of the director of HUD's Center Asset Recovery Division),"
- a specific debt service representative, and
- blank but otherwise negotiable.

Negotiable instruments drawn to multiple, improper, or no payees pose an increased risk to safeguarding assets. As indicated in HUD Handbook 1911.1, a negotiable security may be easily converted to cash.

HUD agreed that there were weaknesses in the prior process for receiving and recording receipts, and on March 30, 2005 implemented procedures to insure that all incoming mail containing debt payments is opened in a single location within the Center and in full view of other employees. The Center should incorporate these changes into its operating procedures.

Proper Reconciliation Procedures Not Performed

Our review of collections during May 2004 also disclosed that prescribed reconciliation and reporting procedures were not always followed. Collections received were not being reconciled to reported lock box receipts as required. Center procedures (paragraph 1-D of the fiscal procedures) require the alternate collection officer to reconcile daily each collection register with Debt Collection and Management System records. This should be performed to confirm receipt of all payments made to the lock box and to ensure that payments are properly posted to the appropriate account within the Debt Collection and Management System or to undistributed credits. However, the alternate collection officer advised us that an Asset Recovery Division team leader selects one collection register sheet per week to verify that all checks for that date were received at the lock box and properly posted to the correct debtor’s account.

The amount reported as the total receipts processed during the test month of May 2004 did not agree with the detailed support attached to the check registers. HUD Handbook 1911.1 provides that all deposit tickets should be supported by an adding machine tape, the list of checks, and the currency collected. The reason for the differing amounts was a clerical error on an adding machine tape attached to one of the daily collection registers.

The above weaknesses in the management controls over collection activities have allowed vulnerable transactions to recur, thus demonstrating the inadequacy of safeguarding measures. HUD advised that the Center had issued written instructions on January 20, 2005 about the need to verify the appropriate posting for every check sent to the lockbox, and implemented a tracking, reporting, and review procedures on January 25, 2005 to monitor this activity. The Center will need to review the results of these procedures and take appropriate action when warranted to ensure that all payments received at the Center are properly recorded and reconciled to the lock box receipts.

Procedures Need to Be Updated.

HUD Handbook 4740.2, “Title I and Other Debt Collection Guidance,” which governs Title I and other debt collection activity, has not been updated since August 1992. Since that time, Congress has passed the Debt Collection Improvement Act of 1996, which centralized the governmentwide collection of delinquent debt and gave the U.S. Department of the Treasury significant new responsibilities in this area. For instance, the law requires federal agencies to refer eligible delinquent debts (more than 180 days) to the U.S. Department of the Treasury for debt collection action. Some Center procedures were implemented via internal memo, as opposed to being incorporated into formal procedures. To ensure that all personnel are aware of the latest procedures, HUD should revise Handbook 4740.2 to reflect the most recent requirements and operating procedures and, thereby, strengthen management controls over compliance with laws and regulations.

Conclusion

Center officials cannot adequately ensure that (1) payments are being sent to the lock box or are being made via electronic funds transfer; (2) collections are properly received, recorded, and reconciled; and (3) procedures are updated. Accordingly, the Center needs to strengthen its internal controls over the receipt, processing, and recording of collections to reduce payments received directly at the Center and to provide assurance that assets are adequately safeguarded and collections are processed most efficiently.

Recommendations

We recommend that the HUD director, Albany Financial Operations Center, Office of Fiscal Services,

1A. Establish controls and procedures to ensure that debtors’ payments are submitted directly to the lock box or are made via electronic fund transfers.

1B. Ensure that all incoming mail containing debt payments is opened in a single location within the Center and in the presence of two individuals.

1C. Implement procedures to ensure that all payments received at the Center are properly recorded and reconciled to the lock box receipts.

1D. Implement action to have HUD Handbook 4740.2 updated to reflect the most recent changes to debt collection procedures.

SCOPE AND METHODOLOGY

Our survey work focused on Title I claim collection activity at the Center in Albany, New York, during fiscal years 2003 and 2004, relating to defaulted Title I property improvement loans and postrepossession defaulted Title I manufactured home loans. To accomplish our objectives, we

- Interviewed HUD/Center staff to obtain a general understanding of the Title I program debt collection operations at the Center.

- Documented the process and key internal controls for recording, monitoring, and collecting of Title I debt.

- Obtained and reviewed financial reports used to monitor and report on debt collection activities.

- Tested and assessed the internal and management controls for compliance with applicable procedures for the recording, monitoring, and collecting of debt.

We performed our work from October 10, 2004, through February 25, 2005, in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal controls are an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that the use of resources is consistent with laws and regulations.

- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources 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 data are obtained, maintained, and fairly disclosed in reports.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

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

- Program operations – Policies and procedures had not been updated.

- Compliance with laws and regulations – The receipt and recording of payments received at the Center did not comply with applicable regulations.

- Safeguarding resources – Significant payments were being received directly at the Center, contrary to the preferred process of using a lock box or electronic funds transfer.

Appendix A

AUDITEE COMMENTS

Auditee Comments

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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

MAY 0 6 2005

MEMORANDUM FOR: Edgar Moore, Regional Inspector General for Audit, 2AGA

FROM: Margaret Young, Deputy Assistant Secretary For Finance & Budget, HW

SUBJECT: Draft Audit Report - Title I Loan Debt Collection

In response to your memorandum dated May 3, 2005, requesting written comments on the subject draft report, we provide the following information.

Finding 1 – Weaknesses Exist in Controls over Title I Program Collections

Recommendation 1A: Establish controls and procedures to ensure that debtors' payments are submitted directly to the lock box or are made via electronic fund transfers.

FHA's Response: FHA agrees "To the extent possible, collections should be processed by wire transfer to Treasury or by a Treasury lockbox bank." as indicated in paragraph 2-1 (a) of HUD Handbook 1911.1 REV-4 and that controls and procedures should be implemented to direct debtors and their agents to remit payments to the lockbox address or via EFT, and to encourage compliance with these procedures.

Procedures that were already in place at the Financial Operations Center (FOC) include: (1) debtors who are on a repayment plan are sent a monthly bill that includes a tear-off payment transmittal slip (that has the lockbox address) and a window envelope; (2) written payment transmittal instructions are provided to other payers that directs them to remit payment to the lockbox; and (3) (as indicated in the draft report) a letter is sent to debtors who remit payments to the FOC to direct them to send future payments to the lockbox.

As indicated in the draft report, on April 1, 2005, the FOC revised its form letters and instructions for submitting payments to provide an address for the lockbox where payments may be sent via courier service in addition to the PO Box number for the lockbox. In email messages issued March 24, 2005, and April 1, 2005, the FOC staff was advised about these changes and the importance of directing all remitters to use the lockbox.

The FOC conducted a study of all remittances received at the FOC during April 2005 to attempt to determine why these payments were sent to the FOC despite the FOC's instructions to use the lockbox address. By June 30, 2005, the FOC will complete its evaluation of this information and will develop and implement additional measures to encourage debtor compliance. These measures will be communicated to the FOC staff via a staff meeting and also communicated and documented via a written Staff Notice.

Recommendation 1B: Develop and implement procedures to insure that all incoming mail containing debt payments is opened in a single location within the Center and in the presence of two individuals.

FHA's Response: FHA does not agree that the previous process for opening the mail and recording any remittances contained therein was "contrary to HUD regulations" as indicated in the draft report. We can find no requirement in HUD Handbook 1911.1 REV-4 that precludes opening such mail at multiple locations or that requires that a second employee "witness and verify the opening of mail containing negotiable instruments" as indicated in the draft report. Rather, paragraph 2-2 b (4) (c) of Handbook 1911.1 states "Mail that may contain checks shall be opened in full view of other employees."

Nonetheless, FHA agrees with the recommendation and the FOC implemented this procedure on March 30, 2005.

Recommendation 1C: Implement procedures to ensure that all payments received at the Center are properly recorded and reconciled to the lock box receipts.

FHA's Response: As indicated in the draft report, the FOC had previously issued reconciliation and reporting procedures to confirm that all payments transmitted by the FOC to the lockbox are properly posted to the appropriate account. To assure that these procedures are always followed, on January 20, 2005, the FOC issued written instructions to the Alternate Assistant Collection Officers and their supervisors that they are to verify the appropriate posting for "every check that we send to lockbox." In addition, the FOC implemented new tracking, reporting, and review procedures to monitor this activity on January 25, 2005.

Recommendation 1D: Implement action to have HUD Handbook 4740.2 updated to reflect the most recent changes to debt collection procedures.

FHA's Response: The FHA agrees that HUD Handbook 4740.2 REV should be updated to reflect the most recent changes to debt collection procedures. The FOC will begin the process to research the applicable statutes, regulations, and other reference resources regarding federal debt collection as well as the regulations, Title I Letters, Mortgagee Letters and other reference resources regarding Title I and FHA programs. With the results of this research, the FOC will rewrite Handbook 4740.2 as necessary and initiate the process to obtain official clearance for the revised handbook. The updated HUD Handbook 4740.2 should be issued by May 15, 2006, subject to timely clearance by the Office of General Counsel, the Office of the Chief Financial Officer or other HUD organizations that must sign off on the revised handbook.

Should you have any questions concerning this response, please contact Mr. Lester J. West, Director, Financial Operations Center, at (518) 464-4200, ext. 4206.