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TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing  
Commissioner, H  
*Joan S. Hobbs*

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region X, OAGA

SUBJECT: The Office of Single Family Housing Expanded Late Endorsement Eligibility  
without Studying Associated Risk

## **HIGHLIGHTS**

### **What We Audited and Why**

We analyzed the impact of recent late endorsement policy changes affecting FHA insured loans and reviewed the decision process followed by the Office of Single Family Housing in approving the rule change. Mortgage Letter 2005-23, dated May 17, 2005, removed the six-month payment history requirement for FHA insurance eligibility for these loans. We selected this mortgage letter for review based on data analyses conducted during our late endorsement audit of Washington Mutual Bank (Report Number 2005-SE-1006). The analyses showed elevated default and claim risks associated with the lender's late endorsed loans.

Our objectives were to determine whether changed late submission for endorsement rules were adequately supported and the decision process documented as required by the Office of Management and Budget and Government Accountability Office requirements and HUD/Federal Housing Administration internal policy and practice.

## What We Found

The underlying risk assumption of Mortgagee Letter 2005-23 is flawed and therefore increases the likelihood of higher default and claim rates for late endorsed loans under the changed rules. Our analysis of late endorsed loans from seven OIG mortgagee audits over the past two years found that loans with unacceptable six month payment histories prior to endorsement had a three and one half times higher risk of insurance claim than the late endorsed loans with good six month payment histories. The Office of Single Family Housing approved the Mortgagee Letter based on the results of a previous data analysis from the Office of Evaluation. However Single Family Housing's use of that data analysis produced a biased result, because it did not include loans rejected for late endorsement because of unacceptable six month payment histories. In citing the study as support for the rule change, staff did not consider this exclusion, and concluded there was no risk in extending endorsement to those same loans through rule change. In addition, documentation of Single Family Housing's decision process was incomplete.

## What We Recommend

We recommend that HUD's Assistant Secretary for Housing-Federal Housing Commissioner (1) rescind Mortgagee Letter 2005-23 until appropriate rule changes can be designed that are supported by an adequate risk assessment considering newly endorsable loans and (2) Establish sufficient documentation practices to document assertions and identify supporting data referenced in published documents such as policies and directives. Documentation should be sufficient to permit a competent and independent management review and create an audit trail.

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

We provided the auditee the draft report on July 7, 2006, and the auditee informed us on August 14, 2006, that they declined to provide written comments to the report.

# TABLE OF CONTENTS

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Background and Objectives	4
Results of Audit	
Finding 1: The Office of Single Family Housing Expanded Late Endorsement Eligibility without Studying Associated Risk	6
Scope and Methodology	13
Internal Controls	14
Appendix	
A. Criteria	15

## BACKGROUND AND OBJECTIVES

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The National Housing Act, as amended, established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides insurance to private lenders against loss on home mortgages. The basic home mortgage insurance program is authorized under Title II, Section 203(b), of the National Housing Act and governed by regulations in Title 24, CFR [*Code of Federal Regulations*] Part 203.

Under the direct endorsement program, the lender underwrites and closes the mortgage loan without prior HUD review or approval and submits the loan to HUD for insurance endorsement. A request for endorsement is considered “late” and triggers additional documentation whenever the binder is received by the Homeownership Center more than 60 days after mortgage loan settlement or funds disbursement, whichever is later. The Federal Housing Administration believes that this is sufficient time for the mortgage lender to assemble the binder, obtain any final documents or signatures, and ship the binder to the appropriate Homeownership Center for endorsement.

“The purpose of late request for endorsement procedures,” as stated in HUD Handbook 4165.1 REV-1, paragraph 3-1, “is to ensure that the degree of risk to the Department is no greater than existed at the time of closing, before the mortgage may be endorsed.” The previous procedures included

- Ensuring that the borrower has made, within the calendar month due, all loan payments up to the time of submission or at a minimum, made six consecutive monthly payments within the calendar month due.
- Requiring that the current month’s payment be received when submitting loans after the 15th of the month.

Based on a 2003 Federal Housing Administration study of loans endorsed under previous rules, the Federal Housing Administration concluded that its history does not show a strong or consistent association between loans submitted late for endorsement and claim rates. The study covered Federal Housing Administration single-family loans from 1999 to 2002 and demonstrated the historical rate of claims was the same whether the loan was endorsed in a timely manner or at a much later date.

On March 31, 2005, the proposed rule change was circulated to appropriate parties for comment, due within two weeks. The Office of Inspector General responded with comments referring to significant noncompliance observed in our recent audits of late endorsements, and recommended increased lender monitoring.

On May 17, 2005, the Federal Housing Commissioner issued Mortgagee Letter 2005-23, which significantly changed the requirements for late endorsements for single-family insurance. The mortgagee letter required the lender to certify that no payment was more than 30 days overdue as

of the date of the certification. It removed the six-month payment history requirement for these loans and provided an additional 15 days grace period before the current month's payment was considered late. The audit objective was to determine whether changed late submission for endorsement rules were adequately supported and the decision process documented as required by Office of Management and Budget and Government Accountability Office requirements and HUD/Federal Housing Administration internal policy and practice. The audit steps were designed to detect inaccuracies and noncompliance by gaining an understanding of the process used and support relied upon to issue the mortgagee letter.

## RESULTS OF AUDIT

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### Finding 1: Single Family Housing Expanded Late Endorsement Eligibility without Studying Associated Risk

On May 17, 2005, HUD's Office of Single Family Housing issued Mortgagee Letter 2005-23, removing the six-month payment history requirement for loans submitted late for endorsement. Although the Office of Single Family Housing asserted the change did not materially increase the Federal Housing Administration's mortgage insurance risk, it did not perform a risk analysis to support this determination. Contrary to this assertion, our review of the performance of loans from seven prior Office of Inspector General (OIG) late endorsement audits found a three and one-half times higher risk of claims when loans had unacceptable payment histories within the prior six months. Further, since the issuance of the mortgagee letter, the default rate for loans submitted late has increased and is significantly higher than the default rate for loans submitted in a timely manner.

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#### **An Office of Evaluation Study Did Not Support Single Family Housing's Conclusions**

Before issuing Mortgagee Letter 2005-23, the Office of Single Family Housing did not perform a risk analysis for newly endorsable loans resulting from the proposed rule changes. Instead, it relied on an Office of Evaluation study of existing single family history of late endorsement loans insured under the previous, more restrictive late endorsement rules. Under the previous rules, if any payments were made after the month due, the loans were required to have six consecutive payments made before or within the calendar month due before endorsement.

The Office of Evaluation study found no correlation between late endorsements and claims under the previous rules. This result demonstrates that the previous six-month rule successfully produced late endorsed loans with the same degree of risk as at the time of closing as required by HUD Handbook 4165.1, REV-1, paragraph 3-1.

However, the Office of Single Family Program Development concluded that since the claim rates are the same, no matter how old the loan is at endorsement, there is no additional risk from older loans and no need for the six-month rule. This conclusion is inaccurate since the Office of Single Family Program Development

did not properly consider the scope of the study, nor did it document any research to determine whether the scope of the study met their needs for this risk assessment.

The study does not address the needs of this risk assessment because it did not include loans with unacceptable payment histories within the prior six months, which became eligible for endorsement when the Federal Housing Administration expanded the rules. These 'missing loans' were in the lender pipelines for endorsement but couldn't qualify for insurance under the old rules. However, they qualify under the new rules, and represent greater risk of future default and claim. Information on these loans are not available in Federal Housing Administration systems but could have been obtained from lenders by the Office of Program Development, had they recognized the need.

The mortgagee letter was conceived during discussions among Office of Single Family staff and drafted without further evidence of study, research, or documentation. According to an Office of Single Family Program Development official, the mortgagee letter is based on the “institutional knowledge” of Federal Housing Administration employees.

In response to comments questioning the risk of these changes during Mortgagee Letter 2005-23’s departmental directives clearance process, the Office of Single Family Housing explained:

“There is no nexus between borrower behavior and the lender’s failure to submit the case binder to Federal Housing Administration within the 60-day window. We believe the 6-month requirement, for which we can find no written justification, is arbitrary and an unnecessary burden imposed on our business partners.”

**Seven Recent Audits Show  
Inappropriate Late Endorsed  
Loans Have Higher Default and  
Claim Rates**

Contrary to the Office of Single Family Housing’s belief that there is no justification for the six-month requirement, we found that loans not meeting this requirement represent a significant risk. In seven OIG late endorsement audits at major lenders, we performed tests to determine whether the lenders complied with HUD’s late endorsement requirements. The audits compared HUD and lender loan data for late submission loans endorsed before the issuance of Mortgagee Letter 2005-23 and tested for the presence of unacceptable payment histories before submission.

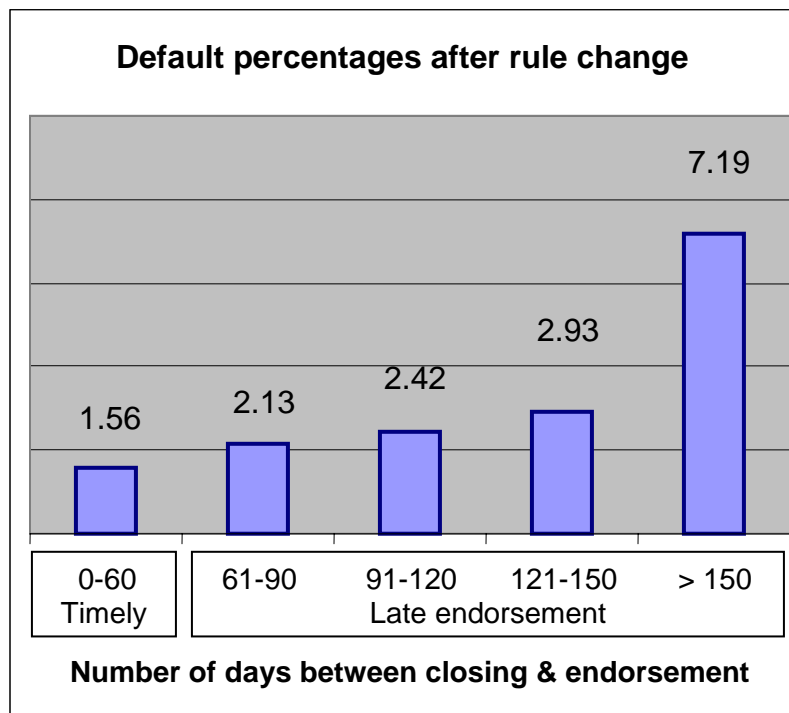
We followed up on the performance of the loans reviewed during these seven audits and compared the performance of the loans with acceptable six-month payment histories to the performance of those loans identified as not having acceptable six-month payment histories. Our review was limited to loans required to comply with HUD's late request for endorsement procedures but did not include late endorsement loans terminated as paid in full and those with a zero dollar mortgage balance. We found that loans with unacceptable payment histories within the prior six months have a three and one-half times higher risk of claims than other late endorsed loans as follows:

<u>Category</u>	<u>Quantity of loans in database</u>	<u>Number of defaults</u>	<u>Percentage</u>	<u>Number of claims</u>	<u>Percentage</u>
Late loans with good six-month payment history	109,666	22,080	<b>20.13</b>	5,566	<b>5.08</b>
Late loans without good six-month payment history	3,610	2,257	<b>62.52</b>	651	<b>18.03</b>

**Since the Rule Change, Late Endorsed Loans Have an Increased Risk of Default**

We also observed a change in trends after implementation of the late endorsement rule changes. After May 31, 2005, loans more than 150 days old at endorsement now default at a rate of 7.19 percent, 4.6 times greater than the 1.56 percent default rate of loans submitted in a timely manner.





Age of loan when endorsed (days)	Timely	Late endorsed					Total
	0-60	61-90	91-120	121-150	> 150		
Quantity of loans in database	255,956	32,798	11,425	4,704	7,452	312,335	
Number of defaults	3,990	700	277	138	536	5,641	

Since the rule change, there has not been sufficient time in which to observe claim activity affected by the change, but the rising default rate provides a strong indication of potential additional claims. Late endorsements decreased somewhat since the rule change, but remain a common occurrence.

**Mortgage Letter 2005-23  
Contradicts HUD Underwriting  
Policy**

The mortgagee letter's elimination of the requirement for an acceptable six-month payment history contradicts established HUD underwriting policy. According to HUD Handbook 4155.1, REV-5, the risk of unacceptable payment histories is a primary consideration in mortgage credit decisions. Paragraph 2-3 states:

“Past credit performance serves as the most useful guide in determining a borrower’s attitude toward credit obligations and predicting a borrower’s future actions. A borrower who has made payments on previous and 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 compensating factors will be necessary to approve the loan.”

The Office of Single Family Housing reiterated this point in its March 23, 2003, response to OIG Audit Report 2003-SE-0001, dated May 15, 2003, Underwriting Practices and Loan Characteristics Contributing to Federal Housing Administration Loan Performance, stating:

“...Federal Housing Administration is indeed mindful of the risk that borrowers who have demonstrated unwillingness or an inability to handle credit may pose to the insurance funds....”

Responding to our recommendation to consider strengthening endorsement procedures for loans with extended delays in submission, especially loans that have no credit scores, the Office of Single Family Housing stated:

“Federal Housing Administration’s Response: Federal Housing Administration concurs with this recommendation. Federal Housing Administration 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.”

### **Internal Control Standards Were Not Followed**

The Office of Single Family Housing’s analysis and management reviews did not detect the mortgagee letter’s errors and oversights because the Office of Single Family Housing lacks adequate documentation to support assertions and to identify supporting data for published documents such as policies and directives.

The Federal Managers' Financial Integrity Act of 1982, as codified in 31 U.S.C. 3512, requires Federal agencies to establish internal accounting and administrative controls to: (1) prevent waste or misuse of agency funds or property; and (2) assure the accountability of assets. Two components of strong internal controls are relevant to the audit results, an audit trail and an adequate risk assessment.

Office of Management and Budget Circular No. A-123, Management Accountability and Control, requires sufficient recordkeeping to provide an audit trail. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

No file or audit trail was created to document the sources of the mortgagee letter's support, whether the sources were relevant, or how conclusions were reached using that support. Also, the purpose and scope of a 2003 study were not sufficiently researched to prevent its misinterpretation. Only the mortgagee letter and supporting verbal discussions were evidence for the management review. Thus the management review failed to identify the oversight in analyzing the risk from newly endorsable loans.

According to HUD Handbook 1840.1 (handbook), section 1-3, and the Government Accountability Office's Standards for Internal Control in the Federal Government (GAO/AIMD-00-21.3.1), HUD is responsible for assessing the risk of activities to determine its susceptibility to losses. Chapter 8 of the handbook requires program offices to determine if a front end risk assessment process for new or substantially revised programs applies. Further, section 8-2 B of the handbook recommends that a front end risk assessment be performed if a revision results in program eligibility requirements. However, a front end risk assessment is required when the revision results in a loss that is greater than \$10 million; and is equal to a change of five percent in the budget line item.

The Office of Single Family Housing had no documentation showing that it went through the process of deciding whether a front end risk assessment was necessary, nor did it perform a basic risk assessment relevant to the mortgagee letter changes. The mortgagee letter is based on verbal discussions drawing from the "institutional knowledge" of Federal Housing Administration employees. These discussions failed to disclose the context of the original study's scope and conclusions.

Based on our observation of the risk, the mortgagee letter changes will result in a loss exceeding the \$10 million threshold and further study is needed to determine whether the overall percentage exceeds five percent in the budget line item. Seven recent late endorsement audits performed by the OIG identified loans with unacceptable payment histories within the prior six months. Those audit results currently show 651 loans in claim status. Assuming an expected loss on these claims of \$29,000 each, HUD could expect losses approaching \$19,000,000 from just these seven lenders.

## Recommendations

We recommend that HUD's Assistant Secretary for Housing-Federal Housing Commissioner

- 1A. Rescind Mortgagee Letter 2005-23 until appropriate rule changes can be designed that are supported by an adequate risk assessment considering newly endorsable loans.
- 1B. Establish sufficient documentation practices to document assertions and identify supporting data referenced in published documents such as policies and directives. The documentation should be sufficient to provide a historical reference and to permit a competent and independent management review and audit trail.

## SCOPE AND METHODOLOGY

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Our objectives were to determine whether changes to Federal Housing Administration late submission for endorsement (late endorsement) rules were accurate, supported, and compliant with HUD/Federal Housing Administration regulations, policies, and practices. The audit steps were designed to detect inaccuracies and noncompliance by gaining an understanding of the process used and support relied upon to issue Mortgagee Letter 2005-23.

To accomplish our objectives, we performed a file review for the mortgagee letter's approval and departmental clearance process, as well as support for the assertions in the mortgagee letter, to evaluate the Office of Single Family Housing's internal controls relating to directives origination. We tested HUD's assessment of risk by observing the performance of previously unendorsable late endorsement loans to determine whether the rule change increased risk to the Federal Housing Administration insurance fund. We also reviewed loan performance for single-family loans before and after the rule change to compare the trend in loan performance for loans of differing ages at endorsement.

We relied on computer-processed data provided by seven Federal Housing Administration late endorsement lender audits and data contained in HUD's Single Family Data Warehouse. We assessed the reliability of these data and conducted sufficient tests of the data to ensure that the data were sufficiently reliable to be used in meeting our objectives. For more information on the individual audits, please refer to the reports below:

Lender	Location	Report no.	Issue date
Cendant	Mount Laurel, NJ	2003-KC-1001	Oct. 2, 2002
First Horizon Home Loans	Irving, TX	2003-KC-1004	Jan. 17, 2003
Wells Fargo	Des Moines, IA	2004-KC-1003	Mar. 23, 2005
RBC Mortgage	Houston, TX	2005-CH-1007	Mar. 29, 2005
Washington Mutual	Seattle, WA	2005-SE-1006	July 5, 2005
National City Mortgage	Miamisburg, OH	2005-CH-1015	Aug. 23, 2005
Major Mortgage	Cheyenne, WY	2006-KC-1004	Jan. 20, 2006

The audit was conducted between February and May 2006. Our review covered the period from August 1, 1999, to February 27, 2006, which corresponds to the timeframe of the seven late endorsement OIG audits of major lenders and extends forward to the most current endorsement data available.

Using HUD's Single Family Data Warehouse system, we collected data for all loans with closing dates from August 1, 1999, to February 27, 2006. The audit universe was limited to loans required to comply with HUD's late endorsement procedures, excluding loans terminated as paid in full and those with a zero dollar mortgage balance. We considered an individual loan subject to the late endorsement procedures if received 66 days or more after the loan closed. This timeframe allows 60 days plus 6 days for HUD processing time and weekend mail time.

We performed our review in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

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Internal control is 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.

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## Relevant Internal Controls

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

- Directives origination process – Policies and procedures that management has in place to reasonably ensure that a HUD directive supports and/or complies with HUD program requirements and to provide approval to submit the directive for clearance.
- Directives management system and the clearance process – Policies and procedures that HUD has in place to reasonably ensure implementation of HUD directives according to both internal and external requirements.

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, we believe the following items are significant weaknesses:

- The Office of Single Family Housing does not maintain adequate records for its departmental directives to provide either an audit trail or a historical reference to supporting detail, analysis, and conclusions.

## APPENDIX

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### Appendix A

#### CRITERIA

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The following requirements relate to the standards for internal control and the assessment of risk:

Office of Management and Budget Circular No. A-123 Management Accountability and Control

**Purpose and Authority.** As Federal employees develop and implement strategies for reengineering agency programs and operations, they should design management structures that help ensure accountability for results, and include appropriate, cost-effective controls. This Circular provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on management controls.

The Circular is issued under the authority of the Federal Managers' Financial Integrity Act of 1982 as codified in 31 U.S.C. 3512.

**Standards.** Agency managers shall incorporate basic management controls in the strategies, plans, guidance and procedures that govern their programs and operations. Controls shall be consistent with the following standards, which are drawn in large part from the "Standards for Internal Control in the Federal Government," issued by the General Accounting Office (GAO).

Specific management control standards include:

- **Recording and Documentation.** Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

The Government Accountability Office's Standards for Internal Control in the Federal Government (GAO/AIMD-00-21.3.1)

**Risk Assessment:**

Internal control should provide for an assessment of the risks the agency faces from both external and internal sources. Management needs to comprehensively identify risks and should consider all significant interactions between the entity and other

parties as well as internal factors at both the entity wide and activity level. Once risks have been identified, they should be analyzed for their possible effect. Because governmental, economic, industry, regulatory, and operating conditions continually change, mechanisms should be provided to identify and deal with any special risks prompted by such changes.

#### HUD Handbook 1840.1, Chapter 1-3, Management Control Program

A. Management controls are policies and procedures adopted by managers to ensure that program objectives are efficiently and effectively accomplished within planned timeframes, within budgetary limitations, and with the intended quality and quantity of output.

B. The management control program includes a risk assessment. Primary organization heads and their managers must review the activities or group of activities in the functional areas to determine susceptibility to losses, which would result if effective management controls are not in place. Also, front-end risk assessments are to be performed for new or significantly revised programs or administrative functions (see chapter 8).

D. Implementation of the management control program requires involvement by managers and supervisors at all levels. All managers and supervisors are responsible for ensuring that adequate management controls exist so that activities under their control are conducted in an effective and efficient manner. Major roles and responsibilities are as follows:

4. Primary organization heads are responsible for program implementation in their respective functional areas. This includes the designation of management control coordinators, evaluation of management controls, implementation of corrective actions, reporting, quality control, and assuring that accountability for management controls is built into all performance evaluation systems.

#### HUD Handbook 1840.1, Chapter 8. Front-End Risk Assessment of New or Substantially Revised Programs or Administrative Functions

8-1 Purpose. This chapter provides policy for the front-end risk assessment process. Front-end risk assessments are documented reviews by management of a component's susceptibility to waste, fraud, abuse and mismanagement. Front-end risk assessments are conducted on new or substantially revised programs or administrative functions. The front-end risk assessment process is designed to be used as a management tool for program offices prospectively to:

- define the proposed control environment;
- identify control risks;



- describe the major controls or systems needing additional controls; and
- document the actions required to reduce these control risks to a tolerable or acceptable level.

The policies and procedures described in this chapter are intended to be followed for only new or substantially revised programs or administrative functions. The policies and procedures contained in this chapter are not applicable for systems development, nor are they intended to be followed in the design and implementation of systems.

- 8-2 Policy. The Secretary, the Deputy Secretary, or the Chief Financial Officer can designate any program, function or activity in HUD for front-end risk assessment review. Assistant Secretaries also are responsible for designating programs, administrative functions, or activities for front-end risk assessment review in their respective area of responsibility. The level of management involvement in the front-end risk assessment process is at the discretion of each primary organization head.
- A. New Programs. At a minimum, each primary organization head must determine for each major new program or substantially revised program or administrative function whether the process described in this chapter applies. In making this determination, it should be noted that it is mandatory that any new program with a funding level totaling \$10 million or more will have a front-end risk assessment performed. For new programs with a funding level of less than \$10 million, it will be at the primary organization head's discretion whether or not a front-end risk assessment should be performed, given other potential risks of the subject program or administrative function under consideration.
- B. Substantially Revised Programs. For a substantially revised program or administrative function, it is recommended that a front-end risk assessment be performed if the revision results in a change in: program eligibility requirements; the manner in which the program funds are delivered to participants; the authorization or benefit limits; and/or HUD staff functions or responsibilities. However, it is mandatory that a front-end risk assessment be performed for any substantially revised program or administrative function when the following two conditions are met:
1. The revision results in an increase or loss that is greater than \$10 million; and
  2. The revision is equal to a change of 5 percent in the budget line item.