audit report

Issue Date June 14, 2006
Audit Report Number 2006-KC-0002

TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

//signed//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: HUD's Systems Usually Prevent Credit Watch-Terminated Lenders from Originating HUD-Insured Loans, But Brief Searches Could Find Additional Loans That Weren't Prevented

HIGHLIGHTS

What We Audited and Why

We audited the Department of Housing and Urban Development's (HUD) Office of Housing to determine whether its controls adequately stop Credit Watch-terminated lenders from originating new loans in the area where they were terminated.

This audit was part of our review of HUD's approval of loan correspondents, which was included in our annual plan.

What We Found

HUD's controls almost always stop lenders from originating new loans in areas where their approval has been terminated. In a recent three-year period, lenders originated 58 insured loans contrary to their sanctions. During the same period, HUD insured over 3.3 million loans.

What We Recommend

We recommend that the Office of Housing periodically search for loans that have been originated by terminated lenders and take appropriate action against the lenders that improperly originated the 58 loans we identified during our search.

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 mailed the draft report to the Office of Housing on January 27, 2006, and requested its comments within 15 days of the receipt of the draft. The Office of Housing provided its written response on February 15, 2006, and generally disagreed with the finding. We discussed the finding with the Office of Housing on February 15, 2006, and as a result made changes to the audit report. The Office of Housing provided its written response to the revised report on March 15, 2006, and continued to disagree with the finding. The Office of Housing requested that we include its original response in this report.

The Office of Housing's comments were based upon the status of the 58 loans as of the date of the draft. We have adjusted the final report to reflect the current status of these loans.

The complete text of the auditee's response, along with our evaluation of that response, is in appendix B of this report.

TABLE OF CONTENTS

Background and Objectives 4

Results of Audit

Finding: Credit Watch-Terminated Lenders Originated HUD-Insured Loans 5

Scope and Methodology 8

Internal Controls 9

Appendixes

A. Schedule of Questioned Costs 10

B. Auditee Comments and OIG's Evaluation 11

BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development (HUD) authorizes lenders to originate single-family mortgage loans and submit them for insurance by entering into an origination approval agreement with the lender. HUD can end the agreement when the lender's loans perform poorly.

Under the Credit Watch Termination initiative, HUD may terminate the origination approval agreement when a lender has a default and claim rate for loans endorsed within the preceding 24 months that exceeds 200 percent of the default and claim rate within the approved geographic area and also exceeds the national default and claim rate. HUD publishes the names of the lenders and the areas covered by the terminations in the *Federal Register*.

As of March 31, 2005, there were almost 23,000 active HUD-approved lender branches. HUD has terminated 300 lenders under its Credit Watch Termination initiative (Credit Watch) since the inception of the intiative on August 1, 1999. Fifteen of the Credit Watch-terminated lenders have been reinstated.

Our initial audit objective was to determine whether HUD's controls over the approval and recertification of loan correspondents ensured that lenders entering the program meet HUD's minimum requirements. We also wanted to determine whether the controls prevented senior officers of loan correspondents that have been sanctioned and terminated by HUD from reentering the program by establishing new lending institutions.

We found that the internal controls over the lender approval process are adequate and that all the loan correspondents in our sample met the minimum lender approval requirements.

We also found that HUD has controls to prevent any individual sanctioned by HUD or by another Federal or State agency from being approved as a principal of a new lending institution. But, it does not have controls to prevent individuals who worked at a lender sanctioned by HUD, but not sanctioned individually, from being approved to participate in the program. This is because HUD cannot legally reject an individual unless the individual has been personally sanctioned. HUD has proposed a rule change that would grant it this authority. The proposed rule will expand HUD's ability to evaluate the previous employment responsibilities and duties and knowledge of wrongdoing for a lender's owners, partners, directors, stockholders, officers and principals. The Office of General Counsel is currently reviewing this proposed rule. Since HUD currently lacks the authority to prevent unsanctioned individuals from participating in the program, we decided not to pursue this issue any further.

While performing the review, we obtained information indicating that some lenders were able to originate loans after they had been credit watch terminated. We then started and finished this audit with an objective to determine whether HUD's controls adequately stop a Credit Watch-terminated lender from originating any new loans in the area under Credit Watch.

RESULTS OF AUDIT

Finding: Credit Watch-Terminated Lenders Originated HUD-Insured Loans

While HUD's controls almost always stopped lenders from originating new loans in areas where their approval has been Credit Watch-terminated, some Lenders were still able to originate loans while they were terminated. As a result, in a three-year period, HUD inappropriately insured 58 loans totaling $6.2 million.

HUD's controls are generally performing as intended. During the audit period, HUD insured about 3.3 million single-family loans valued at $400 billion. For the same period, we found 58 loans totaling $6.2 million originated by lenders under a credit watch termination sanction. While these types of loans represent a very small portion of the single family originated loans, HUD could easily identify them, and thus correct the program violations.

HUD Should Not Have Insured 58 Loans

Credit Watch-terminated lenders are sometimes able to originate HUD-insured loans. We analyzed a list of 300 terminated lenders to determine whether they originated any loans while they were terminated during fiscal years 2002 through 2004. We found 69 loans meeting those conditions. As of March 31, 2005, 11 had been terminated, leaving 58 insured loans totaling $6.2 million. As of May 1, 2006, of the 58 loans, HUD had paid claims on four, and seven others were in default. Three lenders originated 37 of the 58 loans.

Three Reasons for the Exceptions

HUD's controls usually prevent a credit watch terminated lender from entering a new loan in HUD's system. However, there were three circumstances when the controls did not always work.

First, HUD's Computerized Homes Underwriting Management System does not always capture the effective date of the termination in a timely manner. The underwriting system will not prevent lenders from originating new loans in the affected area until a denial date is added to the underwriting system. HUD officials stated that the Quality Assurance Division is diligent in flagging the lenders in its Institution Master File system. HUD believes there is a probem with the interface between the master file and underwriting systems. HUD inappropriately insured 12 loans totaling $1.2 million because the denial dates in the underwriting system were established after the effective date of the termination. The delays ranged from a few days to 11 months.

Second, HUD’s underwriting system allows lenders to originate streamline refinanced loans in any area, including terminated areas. When the underwriting system processes streamline refinances, it follows the rule that if the lender is approved anywhere in the country, it can issue a case number. This caused HUD to inappropriately insure 31 loans totaling $3.5 million.

Third, HUD’s underwriting system allows a principal agent to establish a case on behalf of a terminated lender. A principal agent is a HUD-approved lender designated by another approved lender (principal) to process, underwrite, or submit insurance endorsement requests in the name of and on behalf of the principal under a principal-agent relationship. This caused HUD to inappropriately insure 15 loans totaling $1.5 million.

58 Exceptions identified Out Of 3.3 Million Loans

The volume of loans originated by Credit Watch-terminated lenders increased in fiscal year 2004 primarily due to streamline refinances and the use of principal agents. The following table shows a breakdown of the 58 exceptions.

	2002	2003	2004
Denial date	6	3	3
Streamline refinance	1	7	23
Principal agent	0	1	14
Totals:	7	11	40

During this three year period, HUD insured over 3.3 million loans.

58 Loans Inappropriately Insured

During the three-year period ending September 30, 2004, HUD inappropriately insured 58 loans. As of May 1, 2006, HUD has paid a claim on four of the loans, seven of the loans have terminated and the original mortgage amounts for the 47 active loans total about $4.7 million. HUD has incurred a loss of about $106,000 on two of the claims and has paid claims of about $203,000 on the two other properties, which are currently for sale.

Terminated lenders Should Be Monitored

HUD officials stated that it would be cost prohibitive to enhance the automated systems to work 100 percent of the time. We agree that this problem does not justify a systems modification. But we believe HUD should conduct brief, periodical searches for lenders that are violating their sanctions.

HUD should also take appropriate administrative action against the lenders that inappropriately originated the 58 loans. This should include obtaining indemnification agreements for the 47 active loans and recovering losses from the claims of four loans.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner

1A. Develop and implement a process for monitoring Credit Watch-terminated lenders to ensure that lenders do not avoid HUD's sanction by originating loans in the prohibited area.

1B. Take appropriate administrative action against appropriate lenders for the actively insured loans that they were not authorized to originate. This action includes requiring the lenders to indemnify HUD against future losses on the 47 active loans with original mortgage amounts totaling about $4.7 million, obtaining reimbursement from lenders for claims paid and losses incurred on four loans anticipated to be about $164,000, and/or referring the lenders to the Mortgagee Review Board.

SCOPE AND METHODOLOGY

To accomplish our objective, we conducted interviews with HUD officials and employees. We reviewed the criteria published in the *Federal Register* and HUD handbooks for background information on HUD's programs, processes, and procedures.

We reviewed HUD's controls for approving loan correspondents. To verify whether applicants met the minimum lender approval requirements, we selected a nonstatistical sample of 10 applications with the highest average default rate or loan volume. We selected the applications from a universe of 778 loan correspondents approved by the Office of Lender Activities in calendar year 2004. The results apply only to the items selected and cannot be projected to the universe or population.

We gained an understanding of the controls over the approval and recertification process. The recertification process is automated. The lender electronically submits a recertification fee, audited financial statements, and any business changes. The system automatically performs edit checks to determine the adequacy of the financial statements and ensures that the net worth and other requirements are met. The staff performs a quality control review of 10% of the electronic recertification submissions on a quarterly basis and verifies the financial information by comparing the data with a hard copy of the audited financial statements.

We assessed the lender recertification process at a low risk and did not perform a test of transactions.

We identified a minor weakness in the controls over preventing a Credit Watch-terminated lender from originating a new loan. We analyzed automated data to identify exceptions in which the underwriting system did not prevent a Credit Watch-sanctioned lender from originating a new loan. We included lenders terminated in the first round of Credit Watch, which began on August 1, 1999, through the 22nd round done on March 24, 2005. We matched the list of terminated lenders with all the loans endorsed from October 1, 2001, through September 30, 2004. We provided an exception report to the Quality Assurance Division to verify our results. We did not rely on the data as a basis for our conclusions. Therefore, we did not assess the reliability of the data.

The audit covered the period from October 1, 2001, through September 30, 2004. We performed the audit at HUD's Office of Lender Activities and Program Compliance at 451 7th Street, SW, Washington DC.

We conducted the audit in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that it achieves the following objectives:

- 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 the following internal controls were relevant to our audit objective:

- Controls over preventing Credit Watch-terminated lenders from originating loans within restricted areas.

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

We did not identify any significant weaknesses.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/
1B	$164,523

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations. The amount above reflects HUD's actual loss, or where the final loss is not determined, FHA's average loss experience of about 29 percent of the claim amount (based upon statistics provided by HUD).

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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

FEB 2 1 2006

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

MEMORANDUM FOR: Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

FROM: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H

SUBJECT: Draft Audit Report – Controls over Credit Watch Terminated Lenders

This is in response to the Office of Inspector General's (OIG) draft audit, dated January 27, 2006, on the Office of Housing's controls over the loan correspondent approval process and the process for preventing Credit Watch terminated lenders from originating loans within restricted areas. The Office of Housing disagrees with the findings and recommendations in the report. The Office of Housing has adequate controls to stop Credit Watch terminated lender's branches from originating new loans. Further, the report identified loans that present no material risk to the FHA Insurance Fund.

Comment 1

HUD Controls Over Its Automated System Are Adequate

The Office of Housing reviewed the draft audit report and also reviewed the lenders with branches terminated by Credit Watch for the years 2002-2004. During this period, 175 lender branches were terminated under Credit Watch; these lenders' branches originated over 84,000 loans. The OIG questioned 58 loans and stated "HUD's controls failed." However, if we compare the potential number of loans by the terminated branches (84,000) to the actual number of loans that were originated (58), the automated systems controls were 99.9% effective in preventing new originations. Furthermore, the Office of Housing found that 50 of the 58 loans were either originated under business rules established by the Department, paid in full, or originated during the update of our data system. Consequently, the controls are adequate. Following is a breakdown of the 58 loans.

Loans Identified by OIG	**58**
Paid in-full	(2)
Streamline Refinance Originations Under Allowed Business Rules	(31)
Principal/Agent Originations Under Allowed Business Rules	(15)
Loans Originated During System Update	(2)
Unexplained Loans (7 are active and current)	8

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Comment 2

HUD's automated systems have specific business rules for streamline refinance transactions and Principal/Agent relationship arrangements. For streamline refinance transactions, the business rule is the originating lender is automatically given national approval for transactions of that type. Therefore, as long as the lender has any approved branch they are allowed to process streamline refinance loans. In the Principal/Agent relationship arrangement, the business rule is to rely on the approval status of either party to issue a case number.

A lender's branch is terminated by inputs to the Institution Master File (IMF) data system. The IMF does not provide a real-time update to the Computerized Homes Underwriting Management System—CHUMS, but updates it in one business day. Staff from the Quality Assurance Division verifies that the lender's branch was terminated via displays in the Neighborhood Watch Early Warning System. Based on the fact that the Office of Housing has a 99.9% compliance rate and a process to monitor the process, HUD controls are adequate, and ensure substantial compliance.

Comment 3

Loans Identified In The Audit Present No Material Risk

The draft audit report stated that the streamline refinance loans were inappropriately insured, recommended that the lenders indemnify the loans, and categorized the transactions as "Funds to be put to better use". Streamline refinance loans involve no underwriting, are current obligations to the Department and improve the financial position of the borrower and asset quality for the Department. Streamline refinance loans present no material risk to the FHA Insurance Fund. Therefore, to classify those loans under "Funds to be put to better use" designation is incorrect. Those loans met the requirements for streamline refinance transactions and are fully eligible for insurance. Although we continue to research the 8 unexplained loans, we have determined that 7 out of 8 are current; these seasoned loans are performing favorably.

Responses To The Draft Audit Recommendations

Comment 4

OIG Recommendation No. 1A: Develop and implement a process for monitoring Credit Watch-terminated lenders to ensure that lenders do not avoid HUD's sanction by originating loans in the prohibited area.

Response: The Office of Housing has automated system controls in place to ensure that terminated branches do not originate new loans. Since our compliance rate exceeds 99%, we have determined that our controls and process to monitor the terminated branches are substantially adequate.

Comment 5

OIG Recommendation No. 1B: Take appropriate administrative action against appropriate lenders for the actively insured loans that they were not authorized to originate. This action, at a minimum, should include requiring the lenders to indemnify HUD against future losses on the 55 loans with original mortgage amounts totaling almost $5.9 million.

Response: Administrative action, including indemnification, is not warranted because the automated systems and the lenders operated according to the business rules established by the Office of Housing.

OIG Recommendation No. 1C: Take administrative action that includes obtaining reimbursement from lenders for claims paid and losses incurred on three loans totaling more than $209,700.

Response: Administrative action, including reimbursement, is not warranted because the automated systems and the lenders operated according to the business rules established by the Office of Housing.

I request that you withdraw your recommendations in the audit report.

If you have any questions, please call Joy Hadley, Acting Director, Office of Lender Activities and Program Compliance at 202-708-1515.

OIG Evaluation of Auditee Comments

Comment 1 We revised the final report to remove the statement "HUD's controls failed" and to better explain that this is not a significant control weakness.

Comment 2 HUD's systems do incorporate certain business rules to allow for more efficient processing of all FHA loans. However, we do not agree that HUD should avoid correcting known program violations solely because their automated systems allowed them to occur.

Comment 3 In its response, HUD states that "streamline refinance loans involve no underwriting." This is not true. While the underwriting requirements for streamline refinanced loans are greatly reduced, the lender is still responsible for certain minimum requirements. These include, but are not limited to, ensuring that the transaction involves no cash back to the borrower, a Uniform Residential Loan Application is completed and verified, the mortgage amount does not exceed statutory limits, and that the borrower meets all other eligibility requirements. Credit-qualifying streamline refinanced loans require underwriting consideration similar to regular FHA financing in which the lender must provide evidence of the borrower's acceptable credit history and ability to make payments.

HUD also states that "these loans met the requirements for streamline refinance transactions..." This is also not true. Each loan was originated by a lender that had been terminated by the credit watch process. Section 24, part 202.3, of the Code of Federal Regulations, states that if a mortgagee's origination approval agreement is terminated, it may not originate single family insured mortgages unless the origination approval agreement is reinstated by the Secretary. The termination notice published in the Federal Register further states that termination of the Agreement precludes that branch(s) of the mortgagee from originating FHA-insured single family mortgages within the area of the HUD field office(s) listed in the notice. HUD's regulations prohibit credit watch terminated lenders from originating any loan regardless of the level of underwriting involved in that loan.

The purpose of HUD's credit watch process is to identify and terminate lenders that have poor lending practices. In these cases, each of the lenders was prohibited from originating any loans because they had a past history of originating a higher than average percentage of loans that went into default. HUD asserts that the loans present no material risk to the FHA Insurance Fund. We do not agree that this should be the determining factor as to whether to seek indemnification or other sanctions. Rather, we question why HUD should take on any risk when loans are found to have been originated by lenders who were ineligible to do so. Moreover, the Credit Watch Termination process is less effective as a deterrent to poor underwriting practices, if FHA is not willing to enforce its own requirements.

For these reasons, the lenders should be required to indemnify HUD for any future losses on these loans. Because the scope of our audit did not include a review of the underwriting associated with these loans, we have not assessed whether or not the loans represent an increased risk to FHA. Consequently, in cases where the lenders have not submitted a claim, we modified the report and are not reporting "funds to be put to better use" for these loans.

Comment 4 We believe HUD could implement a very effective solution with a minimal investment of resources. We performed our analysis by matching a list of sanctioned lenders, maintained on an excel spreadsheet, with loan activity obtained from the Single Family Data Warehouse. In addition to matching the lender identification numbers, we matched the field office jurisdiction where the lender was sanctioned with the field office where the loan activity occurred. Then we screened out all loan activity occurring before the effective date of the sanction and after the reinstatement date. Housing could perform a similar test quarterly. The test would be simple and a cost effective means to identify sanctioned lenders that are participating in the program.

Comment 5 As we stated in Comment 2, we do not agree that HUD should avoid correcting known program violations solely because their automated systems allowed them to occur. As we stated in Comment 3, the lenders violated HUD regulations.

For these reasons, we believe it is appropriate to take administrative action against the lenders.