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REPORT BY THE

# Comptroller General

OF THE UNITED STATES

## The Federal Housing Administration Needs Clearer Criteria For Underwriting Single-Family Mortgage Insurance

In three Brooklyn neighborhoods, the Federal Housing Administration rejected applications for mortgage insurance during the initial screening process because the locations of the properties were considered unacceptable. The rejections were based on outdated surveys, and without making required individual inspections. The Federal Housing Administration also inconsistently applied its underwriting criteria in rejecting applications after the initial screening process. GAO believes that, as a result, some applications for mortgage insurance were rejected which should have received additional consideration. GAO is recommending that the Secretary of Housing and Urban Development direct the Federal Housing Administration to clarify existing underwriting criteria governing location and property analysis.



CE-78-59  
MARCH 13, 1978



COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-114860

The Honorable Frederick W. Richmond  
House of Representatives

Dear Mr. Richmond:

In accordance with your May 13, 1977, request and subsequent discussions with your office, we have reviewed the single-family home underwriting practices of the Federal Housing Administration (FHA) Department of Housing and Urban Development in the New York area office. Specifically, in three Brooklyn neighborhoods, the boundaries of which were designated by your office, we

--determined the volume of approvals and disapprovals for single-family mortgage insurance from May 1, 1976, through April 30, 1977, and

--identified the FHA underwriting criteria and determined whether FHA personnel had followed them in approving and disapproving mortgage insurance.

In a December 16, 1977, briefing, we provided your office our review results. We noted that during our review in the designated neighborhoods, FHA personnel

--rejected applications in the initial screening process because of location, based on outdated surveys and without making required individual inspections,

--inconsistently applied the underwriting criteria, and

--did not follow existing criteria, in some cases.

We also advised your office that while we could not determine whether rejections would have been ultimately approved had proper procedures been followed, each case would have received further consideration. We are making recommendations to the Secretary of Housing and Urban Development which, if implemented, should improve FHA underwriting practices. (See p. 12.) As you requested, we did not obtain written agency comments on the results of our review. We did discuss our findings with Department officials, however, and have included their comments in our report. (See p. 11.)

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Details on the results of our review are presented below.

### DEMOGRAPHIC ANALYSIS OF THE DESIGNATED NEIGHBORHOODS

By using 1970 census tract data and information provided by your office, we developed a demographic sketch of the South Williamsburg, Bedford-Stuyvesant, and Crown Heights neighborhoods which you designated for review. The map in appendix I shows these neighborhoods' boundaries.

The designated areas are populated predominantly by ethnic minority groups. The total population of about 300,000 is composed of about 75 percent blacks, 11 percent Puerto Ricans, and 13 percent whites. Approximately 1 percent of the residents are of other ethnic backgrounds. (See app. II.)

About 17,000, or 23 percent, of the approximately 73,000 families in the three designated neighborhoods are below the poverty level. About 8,400, or 11 percent, of the families with incomes below the poverty level receive public assistance. (See app. III.)

The total housing stock consists of about 100,000 structures of which 39,000 are for single-family structures. The remainder are multifamily structures--five or more living units. (See app. IV.)

### SCOPE OF REVIEW

Our review was performed at the Department's New York area office, and in the three designated Brooklyn neighborhoods. We interviewed FHA headquarters and area office officials responsible for processing mortgage insurance applications, analyzed FHA underwriting criteria, and reviewed available approved and disapproved case files for the three neighborhoods from May 1, 1976, through April 30, 1977. We concentrated primarily on how FHA personnel applied the underwriting criteria in processing mortgage insurance applications.

### FHA UNDERWRITING CRITERIA

The National Housing Act (12 U.S.C. 1701 et seq.) provides no detailed basis for FHA underwriting criteria. Section 203(c)

of the act provides that "no mortgage shall be accepted for insurance under this section unless the Secretary finds that the project with respect to which the mortgage is executed is economically sound." What constitutes economic soundness has been left to FHA interpretive discretion. The only source cited for the detailed criteria contained in the various FHA underwriting and valuation handbooks is "prudent business practice."

When mortgage insurance applications are received for properties in older, declining urban areas where greater risks can be anticipated, section 223(e) of the act provides for mortgage insurance where FHA determines the area involved is reasonably viable and the property is an acceptable risk. Under this section mortgages can be insured for the repair, rehabilitation, construction, or purchase of property in older, declining urban areas if the property is "physically" rather than "economically" sound.

#### FHA risk categories

FHA uses a checklist system of risk categories to evaluate mortgage insurance applications. These risk categories include mortgage credit and real estate elements. Application rejection is mandatory if one or more of the features are unacceptable. If all features are at least minimally acceptable, however, the application must be rated acceptable in the category. Unacceptability in one or more categories requires rejection of the application unless the deficiency can feasibly be corrected.

FHA has developed guidelines and procedures to attain consistent underwriting decisions as to when risk features are acceptable. These decisions, however, are still largely a matter of judgment. In addition the relative importance of each category feature depends on the facts of individual mortgage transactions, although credit characteristics of the mortgagor (purchaser) and the relative property marketability will always be important.

#### Mortgage credit risk elements

Mortgage credit analysis establishes the probability that mortgagors will be able and willing to protect their mortgaged property ownership.

FHA relies on readily available credit information. Because of its desire to process applications quickly, FHA does not generally conduct personal interviews and intensive investigations. Reliance is placed on reports from credit agencies with which FHA contracts annually. Reports from noncontract sources are accepted, but processing is slower because information needs to be checked for reliability. Mortgagees (lending institutions) are responsible for seeing that a mortgagor credit report is submitted to FHA with the application for mortgage insurance.

The mortgage credit risk category consists of the following six features.

- Mortgagor credit characteristics.
- Motivating interest in property ownership.
- Importance of monetary interest to the mortgagor.
- Adequacy of available assets for the transaction.
- Adequacy of effective income for total obligations.
- Stability of effective income.

Rejection on any one of these features requires application rejection. If all features are rated acceptable, the application must be rated acceptable in the mortgage credit category.

Real estate risk elements

When FHA analyzes a property and its location, there are three basic considerations:

1. Does the property comply with FHA minimum property standards?
2. Are the property and location at least minimally acceptable based on an analysis of selected risk features under the property and location categories?
3. If the property is minimally acceptable, how are the value and remaining economic life [physical life in the case of Section 223(e)] of the

property affected by a consideration of the risk attributable to the features under the property and location categories?

The principal responsibility for performing both location and property analyses belongs to the appraiser. Appraisers are either FHA staff appraisers or private "fee appraisers." The location analysis is performed first. The application may be rejected for location considerations before an analysis of property soundness is conducted.

Location analysis--Analysis of a location is made by appraisers to determine acceptability. For those locations which are minimally acceptable, characteristics affecting the property's value and economic life are identified.

The rejection of a location is warranted in instances in which the property being appraised is subject to hazards, noxious odors, offensive sights, or excessive noises to the point of endangering its marketability and physical condition or the health and safety of its occupants. The severity of these instances is determined subjectively by the appraisers.

The estimate of value and remaining economic life may reflect the full range of specific location-related risk factors and more general factors. These include the probability of income-related change which will tend to change desirability for residential purposes or local market reactions to immediate or long-range conditions.

Property analysis--Six risk features of property analysis are

- visual appeal,
- livability,
- structural quality,
- resistance to elements and use,
- suitability of mechanical equipment, and
- conformity of property to neighborhood.

The purpose of property analysis is to determine the effects of these factors on the present and continuing marketability of the property and the comfort, convenience, health, and safety of its occupants. The assessment of this impact is also a subjective appraiser decision.

#### PROCESSING OF APPLICATIONS

Applications must pass through three phases before FHA can insure the mortgage. The application is examined for (1) its completeness and location acceptability, (2) specific property condition and value, and (3) credit acceptability of the potential mortgagor.

Before it is accepted and assigned a case number, the application is examined for completeness and location acceptability. Once the location is found acceptable, a case number and appraiser are assigned to continue the application processing. The appraiser reviews the specific property mainly for condition and value. The mortgage credit section analyzes the credit aspects of the case for acceptability within the National Housing Act statutory limitations.

#### ACTIVITY IN DESIGNATED NEIGHBORHOODS

Based on our review of available records at the FHA New York area office, we identified 145 applications from the three designated neighborhoods on which determinations were made for the period May 1, 1976, through April 30, 1977. As shown in the following table, 48 applications were approved and 97 were rejected. The 97 rejections include 34 rejections before application acceptance and 63 rejections after property appraisal.

Case Totals  
In Designated Neighborhoods  
May 1, 1976, through April 30, 1977

<u>Activity</u>	<u>South Williamsburg</u>	<u>Bedford- Stuyvesant</u>	<u>Crown Heights</u>	<u>Total</u>
Approvals	<u>0</u>	<u>19</u>	<u>29</u>	<u>48</u>
Rejections:				
Preapplica- tion acceptance	1	24	9	34
Post applica- tion acceptance	<u>0</u>	<u>31</u>	<u>32</u>	<u>63</u>
Total rejections	<u>1</u>	<u>55</u>	<u>41</u>	<u>97</u>
Total cases	<u>1</u>	<u>74</u>	<u>70</u>	<u>145</u>

The bases for the rejections are discussed below.

EVALUATION OF FHA UNDERWRITING PRACTICES

During our review, FHA rejected 15 property loan applications in its initial screening based on outdated location surveys without making the required individual inspections. Further, in 16 cases of rejection, after initial screening, the underwriting criteria were not applied consistently. In some cases determinations were made without conforming to existing criteria. We could not determine whether these applications would have ultimately been approved had proper procedures been followed. Each application would have received further consideration, however.

Application rejection during  
the initial screening

Before FHA accepts mortgage insurance applications for processing, various conditions can cause rejection. These rejection conditions may include (1) location survey results which have identified uninsurable locations, (2)



incomplete applications, and (3) inadequate related documentation.

As previously mentioned, 34 applications were rejected before acceptance for processing. Inadequate documentation and incomplete application forms accounted for 19 of these rejections. Fifteen additional applications were rejected because the property locations were considered unacceptable based on surveys made primarily in 1972. We were informed by underwriting personnel that a rate of 10 percent or greater of abandoned or burned out buildings was used as a rule of thumb in determining areas where a mortgage would not be insurable.

According to FHA underwriting criteria, properties will not be rejected unless specific, adverse influences seriously affect livability, marketability, or occupant health and safety. FHA criteria also calls for inspection of the property on a case by case basis to determine if property and location eligibility criteria are met.

FHA personnel did not follow prescribed underwriting criteria in rejecting these 15 applications because they did not inspect the specific properties in question. Our tour of the designated neighborhoods, using the FHA 10 percent rule of thumb, indicated that if FHA personnel had inspected the 15 properties before making their determinations, five applications would have been accepted for processing.

In July 1977, approximately the same time that we notified the FHA New York area office of our impending review, the area office began routine location inspections for each application, involving property located in previously determined problem areas.

#### Inconsistent application of underwriting criteria

Our review of 94 of 111 approved and rejected FHA applications, revealed various inconsistencies in applying FHA underwriting criteria. We attributed these inconsistencies to the fact that the criteria provide wide latitude for the acceptance or rejection of single-family mortgage insurance applications. (Files for the remaining 17 applications were not available.) Based on our comparison of 57 rejected and 37 approved applications, we believe 16

applications should not have been rejected without additional consideration. Some examples of these inconsistencies follow.

Property repairs

According to the underwriting criteria, existing dwellings being considered for mortgage insurance must comply with the general requirements of FHA minimum property standards. Where properties are not in compliance with the applicable standards, and corrections are feasible, corrections may be stipulated in the underwriter's report for valuation purposes. If compliance can be effected only by major repairs or alterations, the property must be rejected and the reasons must be explained in the report. FHA criteria stipulate that "repairs will be limited to those necessary to preserve the property and to protect the health and safety of the occupants."

Of the 16 questionable rejected applications, 5 were rejected because of needed "deferred maintenance." As noted above, the only specificity in FHA criteria relates to the achievement of FHA minimum property standards. There are no definitions of deferred maintenance or any criteria specifying what constitutes a major repair or alteration which would require rejection or permit acceptance. For example:

--The five cases in question showed deferred maintenance as being "severe" in one case, "extreme," "excessive," and "general," in three cases, respectively, and included only a statement of the various conditions of deferred maintenance in the last case.

--Two of the cases showed the costs of required repairs at about 2 percent of the appraised value, while the remaining 3 cases had no such statement.

While underwriting personnel rejected these five cases because they judged the required repairs or alterations to be of major proportions, we noted other cases with costlier required repairs that were approved. For example:

--One case was approved even though the cost of required repairs was 7 percent of the appraised value. These repairs included scraping and painting the exterior, installing a new roof and electrical wiring, repairing damaged ceilings, and restoring and replacing windows and frames.

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--Another case with required repairs totaling 5.8 percent of the appraised value was approved even though we found no evidence that the repairs were ever made. These repairs included the installation of a 30-foot main support girder and the removal of dirt from the cellar foundation wall where excavation had been done.

### Livability

The underwriting criteria concerning livability involve comfort, convenience, and safety as related to good design and efficient site and interior space utilization. Three of the 16 applications were rejected because the underwriting personnel judged the property livability to be below standard and the needed corrections to be major. We question these determinations. For example:

--"Livability" was the stated reason for rejection because the first and third floor bathrooms of the residence contained only two pieces of equipment. The cost of required repair was shown to be \$1,200 which was only about 3.5 percent of the \$34,000 appraised value. We believe that this repair could have been made a condition for mortgage insurance.

--In the two remaining cases, rejections because of "livability" were based on bathroom and kitchen facilities being located in public halls. No cost of required repairs was shown on the appraisal form.

Although FHA rejected the above applications based on the livability standard, we noted an approved application which included a condition requiring elimination of access to a bathroom from a public hall, a condition very similar to those in the rejected applications above.

### Other questionable applications

Of the remaining eight applications, five involved combined reasons for rejection, including major deficiencies, poor visual appeal, and inadequate livability. There was insufficient documentation, however, to support the various reasons for rejection. One other application was rejected because the structural quality of the building was questioned, but there was no indication of the cost of required repairs.

The final two applications were rejected because of property location. There was no indication that either of

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these applications was reconsidered under section 223(e), as provided for by the underwriting criteria. Failure to reconsider applications appears to have been an oversight, however, because we noted that the section 223(e) was implemented in other cases.

#### Nonconformance with existing criteria

Before final rejection because of location, FHA's underwriting criteria require that FHA personnel contact local authorities, to request correction of environmental factors causing the rejection. We found no evidence that this step had been taken by New York area office personnel.

We also noted seven applications in which desk reviews of appraisals were not performed. This review is a required procedure for the home mortgage valuation section.

#### CONCLUSIONS

The Department of Housing and Urban Development New York area office did not follow prescribed underwriting criteria when, without inspecting related properties, it rejected certain loan applications in the initial screening, based on location. Corrective action was taken on this matter in July 1977.

Inconsistencies in the interpretation and application of underwriting criteria by the Department's New York area office appear to be the result of insufficient guidance from Department headquarters in Washington.

#### AGENCY COMMENTS

Area and regional officials of the Department told us that, since July 1977, corrective action had been taken on inspecting specific properties prior to making locational determinations. They agreed that our examples showed inconsistencies and nonconformance with FHA underwriting criteria and said that corrective action would be taken on these points. The officials also said that in certain cases, however, determinations could be considered appropriate because of the wide latitude allowed in interpreting FHA criteria. Area officials said that the mortgagee has the right to challenge any rejection within 60 days following the determination.

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An FHA headquarters official told us that he was aware of the inconsistent application of underwriting criteria throughout the regional offices and that regional management of the program could be improved.

RECOMMENDATIONS TO THE SECRETARY OF  
HOUSING AND URBAN DEVELOPMENT

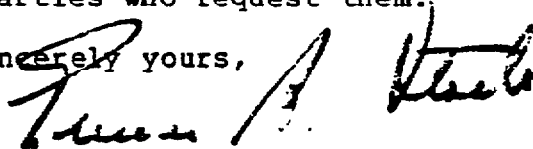
To assure consistency in underwriting practices nationwide, we recommend that the Secretary of Housing and Urban Development direct FHA to clarify existing underwriting criteria governing location and property analysis. Specifically, we recommend that FHA be directed to define deferred maintenance, major repairs, and livability conditions used to approve or reject insurance applications, and better define when the correction of these elements can be made a condition for mortgage insurance application approvals.

To obviate the conditions noted in the New York area office regarding the rejection of applications based on location, during initial screening, we also recommend that the Secretary emphasize to the area offices that such rejections for location should be made only after actual property inspections and not based on general location surveys.

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As arranged with your office, we are sending copies of this report to the Secretary, Department of Housing and Urban Development; the Chairmen, Senate Committee on Governmental Affairs; House Committee on Government Operations; and House and Senate Committees on Appropriations; and other interested congressional committees. Copies will also be available to other interested parties who request them.

Sincerely yours,



Comptroller General  
of the United States



RACIAL COMPOSITION OF NEIGHBORHOODS

	<u>South Williamsburg</u>	<u>Bedford- Stuyvesant</u>	<u>Crown Heights</u>	<u>Total</u>	<u>Percent</u>
White	6,180	8,385	25,695	40,260	13
Black	1,348	139,393	84,185	224,926	75
Puerto Rican	9,805	17,156	6,889	33,850	11
Other	<u>205</u>	<u>670</u>	<u>1,645</u>	<u>2,520</u>	<u>1</u>
Total	<u>17,538</u>	<u>165,604</u>	<u>118,414</u>	<u>301,556</u>	<u>100</u>

INCOME LEVEL OF NEIGHBORHOODS

	<u>South Williamsburg</u>	<u>Bedford- Stuyvesant</u>	<u>Crown Heights</u>	<u>Total</u>	<u>Percent</u>
Families in area	4,112	38,997	29,882	72,991	100
Families below pov- erty level	1,275	10,199	5,525	16,999	23
Families be- low poverty level on public as- sistance	616	5,214	2,534	8,364	11



HOUSING STOCK IN NEIGHBORHOODS

	<u>South Williamsburg</u>	<u>Bedford- Stuyvesant</u>	<u>Crown Heights</u>	<u>Total</u>	<u>Percent</u>
Single- family	1,279	25,995	11,742	39,016	39
Multifamily	<u>4,054</u>	<u>26,593</u>	<u>30,679</u>	<u>61,326</u>	<u>61</u>
Total	<u>5,333</u>	<u>52,588</u>	<u>42,421</u>	<u>100,342</u>	<u>100</u>

**DOCUMENT RESUME**

**05498 - [B0865761] (Restricted)**

**[Application of Provisions of Annual and Sick Leave Act to Commissioners of Copyright Royalty Tribunal]. B-19104. March 21, 1978. 2 pp.**

**Letter to Thomas C. Brennan, Chairman, Copyright Royalty Tribunal; by Paul G. Deabling, General Counsel.**

**Contact: Office of the General Counsel: Civilian Personnel.  
Authority: Annual and Sick Leave Act of 1951, as amended (5  
U.S.C. 63). (P.L. 4-553; 90 Stat. 2541).**

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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

*B. Putnam*  
*CP*

OFFICE OF GENERAL COUNSEL

In reply refer to  
B-191044 (BRP)

March 21, 1978

*Do not make available to public...*

Thomas C. Brennan, Chairman  
Copyright Royalty Tribunal  
1111 20th Street, N.W.  
Washington, D.C. 20036

Dear Mr. Brennan:

Further reference is made to your letter of December 28, 1977, in which you seek clarification as to the legislative intent of Public Law 94-553, October 21, 1976, 90 Stat. 2541, a law for the general revision of the copyright law, which, among other things, established the Copyright Royalty Tribunal (CRT) as an independent agency in the legislative branch of the Federal Government. In this regard, you ask whether the provisions of the Annual and Sick Leave Act of 1951, as amended, and as presently codified in chapter 63, title 5, United States Code, are applicable to the Commissioners of the CRT.

By letter dated January 27, 1978, you forwarded a copy of a letter dated January 10, 1978, addressed to you from the Honorable Robert W. Kastenmeier, Chairman, Subcommittee on Courts, Civil Liberties and the Administration of Justice, House of Representatives, United States Congress. Mr. Kastenmeier states, in essence, that as Chairman of the House Subcommittee which drafted the revised structure of the CRT and as Chairman of the House conferees, it was his intent that the Commissioners should be equal in all matters, including compensation and personnel benefits. He feels that a holding that the Leave Act applies to the Commissioners would be inconsistent with the intent of section 802 of Public Law 94-553 since it would result in the leave time of the Commissioners varying on the basis of prior creditable Federal service, if any. He further points out that if the Leave Act applies to the Commissioners, employees of the CRT could receive more leave time than the Commissioners, a situation that presently exists within the Tribunal. Mr. Kastenmeier concludes by stating that he did not intend such a result, nor in

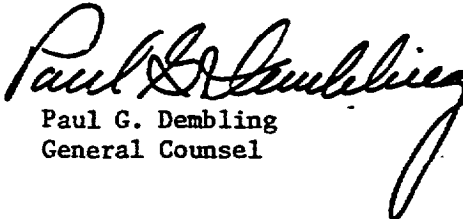
B-191044

his opinion is that result required by a reasonable construction of the relevant language of chapter 8 of Public Law 94-553.

While we are cognizant of the salient points made and the conclusion reached by Mr. Kastenmeier, our preliminary research leads us to believe that the Commissioners of the CRT are included within the provisions of the Annual and Sick Leave Act of 1951, as amended. This is based on our review of the legislative histories of the Annual and Sick Leave Act of 1951, as amended, and Public Law 94-553; the pertinent court decisions; decisions of the Comptroller General of the United States; regulations issued by the United States Civil Service Commission; and informal contact with officials of the Commission. If the Commissioners are to be excepted from coverage under the Leave Act, we believe that legislative action would be necessary.

We would be happy to discuss this subject with you or, if you prefer, issue a formal opinion in the matter.

Sincerely yours,



Paul G. Dembling  
General Counsel