REPORT BY THE U.S.

General Accounting Office

Stronger Internal Controls Over HUD Single-Family Mortgage Insurance Programs Would Discourage Fraud

This report examines the circumstances that allowed real estate speculators in Camden, New Jersey, to defraud the federal government by falsifying information submitted to private lenders in obtaining HUD insured loans. GAO believes that HUD's procedures could be strengthened to provide additional safeguards against such fraudulent behavior and recommends that HUD

--obtain data from lenders on loans where borrowers stop paying shortly after loan origination (perhaps during the first 12 months) in order to detect adverse trends and investigate why homeowners failed to pay and

--independently verify data concerning the borrower's ability-to-pay on a statistical sample of all loans.

GAO/RCED-85-4
MAY 13, 1985

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

RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DIVISION

B-211508

The Honorable Bill Bradley
United States Senate

The Honorable Frank R. Lautenberg
United States Senate

The Honorable Max Baucus
United States Senate

The Honorable Donald W. Riegle
United States Senate

As requested in your letter of January 27, 1984, this report evaluates the Department of Housing and Urban Development (HUD) procedures for approving insurance on single-family home loans.

We found that HUD does not have the data needed for identifying and evaluating adverse trends resulting from its single-family mortgage insurance commitment process. We believe the recommendations included in this report, if implemented, would strengthen HUD's existing procedures, thereby, reducing the probability of potential losses.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from the date of the report. At that time we will send copies to the appropriate House and Senate committees; the Secretary of Housing and Urban Development; the Director, Office of Management and Budget; and other interested parties.

J. Dexter Peach
Director

The Veterans Administration (VA), which is also a large insurer of home loans, has similar procedures that it believes help to discover and discourage fraudulent and abusive practices. (See pp. 12 and 13.)

Such procedures will become even more important in the future because HUD plans to shift responsibility for loan approval and insurance decisions to lenders. (See p. 20.)

GOVERNMENT INSURANCE
ELIMINATES LENDER RISK

HUD's mortgage insurance programs date back to the National Housing Act of 1934. A single mortgage insurance program enacted then has evolved into a variety of specialized programs serving specific social goals. For example, HUD has programs for low- and moderate-income buyers and for properties located in distressed areas. All these programs liberalize mortgage credit terms for Americans who might otherwise find it difficult to obtain loans in the private market. (See pp. 1 and 2.)

Every home loan has some risk that it will not be repaid. HUD's single-family loan insurance programs protect lenders from this risk. The insurance, therefore, attracts private capital at better terms for targeted borrowers who generally have smaller downpayments and higher debt-to-income ratios than borrowers with uninsured loans. This is possible because the investment is virtually risk free for the lender. If a borrower stops making payments, the lender forecloses, and HUD pays off the loan and any expenses in exchange for the property. (See pp. 1, 2, and 3.)

Since inception in 1934, HUD's single-family mortgage insurance programs have insured about 14 million loans. Roughly 800,000 or 6 percent of these loans have failed. Even though HUD has collected insurance premiums from borrowers which help offset the resulting losses, the insurance programs have still lost several billions of dollars. (See p. 3.)

GENERAL ACCOUNTING OFFICE
REPORT TO THE HONORABLE
DONALD W. RIEGLE, FRANK R.
LAUTENBERG, MAX BAUCUS,
AND BILL BRADLEY
UNITED STATES SENATE

STRONGER INTERNAL CONTROLS OVER HUD'S SINGLE-FAMILY MORTGAGE INSURANCE PROGRAM WOULD DISCOURAGE FRAUD

D I G E S T

The Department of Housing and Urban Development (HUD) is the nation's largest insurer of single-family home loans. As of September 1984, HUD was insuring over 5 million loans with an outstanding balance of $135 billion. (See p. 1.)

In January 1984, Senators Donald W. Riegle, Frank R. Lautenberg, Max Baucus, and Bill Bradley requested that GAO study HUD's single family insurance and property disposition policies with some special attention to problems reported in Camden, New Jersey, by the news media. The request was made because of an alleged fraudulent housing scheme involving several hundred loans in Camden, New Jersey. At the time of the request, a task force composed of HUD's Inspector General's Office, the Federal Bureau of Investigation, and the Internal Revenue Service had been investigating the Camden problem for some time. These investigations have led to several convictions. (See p. 7.)

Because of the task force investigation, GAO limited its study to an analysis of HUD's home loan insurance approval procedures. GAO studied records regarding the problem in Camden, made an analysis of HUD's insurance approval procedures, and visited officials and reviewed practices and procedures at HUD headquarters and two HUD field offices. GAO concluded that to reduce the probability of problems, such as those that occurred in Camden, HUD should institute internal control procedures to

--determine the reason why loans insured fail shortly after they were made and

--routinely sample and verify information that lenders use in approving HUD insured loans. (See p. 23.)

EFFECTIVE INTERNAL CONTROLS COULD ENHANCE HUD'S DETECTION OF FRAUD

Internal controls are procedures designed to reduce the likelihood of fraud or abuse. If effective, internal controls should, among other things, increase the probability of detecting fraud and abuse and prevent any one individual from controlling all key aspects of the insurance process.

HUD relies on lenders to obtain and verify information needed to determine the financial capacity of borrowers to repay and upon independent appraisers to estimate the property value. HUD concentrates its efforts on compliance with program requirements by reviewing documentation submitted by the lender. HUD does not independently verify the information submitted by the lender, although it does redo appraisals on about 10 percent of its insured loans. (See p. 10.)

Given the level of risk which HUD assumes and its complete reliance on its lenders to protect its interests, GAO believes that HUD's internal controls should be strengthened. In Camden, according to the news media, a number of patterns were apparent in the loans involved in the investigation. For example, a single lender made many of these loans (see p. 10), the same real estate company sold a large number of the properties (see p. 5), and many of the home buyers had no credit history (see p. 5).

A procedure to identify why loans default shortly after origination would greatly increase HUD's chances of detecting and analyzing problems and, in turn, developing additional controls as necessary. Such a procedure could even reduce the resources needed to control risk by using more labor-intensive methods only in localities where they are needed as opposed to implementing the same controls nationwide.

Another problem in Camden was that lenders accepted misleading information regarding the identity of borrowers and their financial qualifications and relied upon this information in approving mortgage loans and obtaining HUD's insurance. Nothing in HUD's present procedures could be expected to detect this kind of problem. (See p. 17.) If, however, HUD independently verified the information submitted by lenders on a sample basis, such verification would not only help detect problems but would also serve as a deterrent to those who wished to defraud the government.

THE VETERANS ADMINISTRATION USES SIMILAR CONTROL PROCEDURES

Even though VA insures less risky loans than HUD, VA independently verifies insurance commitment data submitted by lenders--on a sample of loans--and identifies why borrowers default within a short period of time after loan origination. VA identifies and evaluates why borrowers default within the first 3 months and modifies the insurance approval process in individual field offices as needed. For example, the Philadelphia VA office noted several defaulted loans where borrowers stopped paying because of excessive debt obligations, yet credit reports obtained by the lender showed the borrowers had no previous credit history. The VA office subsequently adjusted its insurance commitment process to independently verify such credit reports. (See p. 17.) In another instance, the Philadelphia VA office decided to independently verify all data on insurance applications from one lender with a number of problem loans, even though VA's national policy required only a 10-percent sampling. (See p. 12.)

Additionally, the Philadelphia office monitored all loans where the borrowers defaulted within 1 year of origination instead of the national policy of only looking at loans defaulting within 3 months of origination. The VA's Chief of Mortgage Credit said that this modified procedure provides greater protection against fraudulent and abusive practices going undetected. In light of the fact that the real estate broker convicted in Camden made the first three mortgage payments in an attempt to avoid detection, the VA official's position appears valid. (See p. 14.)

HUD WILL RELY EVEN MORE ON LENDERS IN THE FUTURE

HUD is currently implementing the Direct Endorsement Program in which lenders will have the authority to issue HUD insurance commitments without prior HUD approval. These lenders, while committing the government to insurance, will not assume any additional financial risk. The Direct Endorsement Program is intended to simplify and expedite the loan origination process.

HUD plans to monitor participating direct endorsement lenders by collecting data on all loans and reviewing a sampling of loan files. The procedure's objective is to rate the lenders' performance in terms of good, fair, or poor--if continuously poor, the lender could be barred from the Direct Endorsement Program. Although the insurance commitment file submitted by lenders includes considerable data on each insurance commitment, HUD still will not know the reasons mortgages failed or are failing. Without such knowledge, appropriate internal control techniques cannot be devised or modified to handle local risk conditions. Additionally, HUD does not intend to independently verify information submitted by the lender.

RECOMMENDATIONS TO THE SECRETARY OF HUD

To improve HUD's insurance approval process and reduce losses, GAO recommends that the Secretary of HUD develop procedures to

--obtain data from lenders on loans where borrowers stop paying shortly after loan origination (perhaps during the first 12 months) in order to detect adverse trends and investigate why homeowners failed to pay and

--sample insurance applications submitted by lenders and independently verify information on the borrower's ability to pay, such as the borrower's income and credit history. (See p. 23.)

GAO also makes other recommendations directed at revising HUD's insurance commitment procedures. (See p. 23.)

AGENCY COMMENTS AND GAO'S EVALUATION

HUD said that it is modifying its Single-Family Default Monitoring System so that it can be used with the Computerized Home Underwriting Monitoring System. HUD said that it will be able to capsulize the appraisal and credit data for each loan transaction after the system is completed. HUD estimated that it will be the middle of 1986 before the system will be operational and able to provide data necessary to monitor insurance-in-force and specifically, defaulted mortgages. Because the system is not fully developed, GAO is not in a position to determine if HUD's modified system will provide the data necessary to effectively monitor mortgage insurance activities. (See p. 23.)

To address GAO's concerns, HUD, in the interim, has taken a number of steps to identify fraudulent and abusive practices. For example, HUD is requesting that its field offices review data provided by lenders during the processing of HUD's homeowner assistance (Assignment) program to determine if the mortgage default occurred in the first 6 months after loan origination. In addition, HUD has directed its Property Disposition Branch to review the forms submitted by lenders as part of the insurance claims foreclosure package to identify early mortgage defaults.

GAO's evaluation of these steps, however, leads it to believe that HUD still will lack the necessary data to effectively identify fraudulent and abusive practices. Under the assignment program, HUD, if requested by the lender and the homeowner, can take over the mortgage from the lender to give the homeowner additional time to avoid foreclosure. The problem with using this process as a vehicle to identify fraudulent and abusive insurance practices is that HUD's assignment program is voluntary. Therefore, it is unlikely that lenders and homeowners will request HUD's assistance under the assignment program if they obtained the loan under fraudulent conditions.

CHAPTER 1

INTRODUCTION

To assist individuals in financing home purchases, the Department of Housing and Urban Development (HUD) operates single-family mortgage insurance programs to protect lenders against borrowers who default and subsequently lose their homes through foreclosure. As of September 30, 1984, HUD had insurance-in-force on over 5 million loans totaling about $135 billion.

WHAT RISK DOES MORTGAGE FINANCING ENTAIL?

Home mortgage lenders generally face two types of risk when financing mortgages. The initial risk relates to the buyer's ability to make monthly payments on the mortgage loan. This risk is evaluated by assessing a buyer's income, assets, indebtedness, employment, and credit history. The second risk pertains to the lender's ability to sell the borrower's property and recoup the unpaid loan balance should foreclosure become inevitable. This risk is evaluated by determining the difference between the reasonable value of the property and the borrower's down payment. The greater the down payment, the lower the risk because the homeowner has a financial incentive to sell the house and pay off the mortgage rather than lose the house through foreclosure. To reduce the risk posed by homeowner default and subsequent foreclosure, lenders seek either private sector or federal government mortgage insurance.

PURPOSE AND AUTHORITY OF HUD'S MORTGAGE INSURANCE PROGRAM

Title II of the National Housing Act of 1934, as amended (12 U.S.C. 1707 et seq.), authorizes HUD to insure mortgages for all qualified buyers who purchase new and existing homes (of up to four separate units), mobile homes, or condominiums. HUD operates three separate insurance funds within the overall single-family program: (1) a mutual insurance fund, (2) a general insurance fund, and (3) a special risk insurance fund. Table 1 shows the differences between the funds and depicts the major insurance program within each fund. Each fund is composed of multiple programs tailored to specific population groups. In addition, individual programs entail varying degrees of risk and have distinct features such as eligibility requirements.

Table 1

Federal Housing Administration

Single-Family Mortgage Insurance Funds

Insurance fund	Total mortgages outstanding September 30, 1983	Major insurance program	Major insurance program characteristics
Mutual	4,124,166	Section 203 (b) 3,740,535[a]	Supported by insurance premiums with excess premiums being returned to homeowners. Mortgages for general population. Maximum loan amounts. Requires minimum down payment.
General	566,314	Section 221(d)(2) 405,956[a]	Supported by insurance premiums and congressional appropriations. Mortgages for special group of borrowers--displaced and lower income. Maximum loan amounts lower than mutual fund. Lower down payment requirements than mutual fund.
Special risk	445,273	Section 235 347,861[a]	Supported by insurance premiums and congressional appropriations. Mortgages for low-income borrowers. Mortgage interest subsidies provided. Maximum loan amounts lower than mutual fund.

[a]/Mortgages outstanding.

Source: Summary of Mortgage Insurance Operations, fiscal year 1983, U.S. Department of Housing and Urban Development.

Currently, HUD is the largest insurer of single-family loans in the nation with over 5 million loans and an outstanding balance of $124 billion as of September 30, 1983. In fiscal year 1983, HUD approved 428,207 mortgage insurance applications totaling $22.3 billion of insurance. HUD insures mortgage loans for up to 97 percent of the first $25,000 of appraised value and up to 95 percent above that for up to 35 years. Loan limits based on appraised property value vary depending on the type of home and its location. For example, a loan could be as high as $90,000 for a single-family home in a high cost area or $67,500 in a lower cost area.

HUD'S PROCESS FOR APPROVING SINGLE-FAMILY MORTGAGE INSURANCE APPLICATIONS

An authorized lender initiates the mortgage insurance application process by submitting property and borrower information to HUD. An approved HUD or Veterans Administration (VA) appraiser assesses the property to be insured. Subsequently, the lender verifies the applicant's employment status and assets. In addition, the lender obtains a current credit report that displays an applicant's credit history. HUD reviews the information submitted by the lender before approving the insurance commitment. (See fig. 1, p. 4.) HUD recently initiated a program--the Direct Endorsement Program--that authorizes approved lenders to commit HUD to providing mortgage insurance without a prior review by HUD.

LOSSES CAN BE EXPECTED IN MORTGAGE INSURANCE PROGRAMS

Losses are a natural result of any mortgage insurance program. Since 1934, HUD's insurance funds have experienced a loss of about $4 billion[1] on mortgages with an insured value of about $240 billion. The loss represents the difference between income--mainly insurance premiums paid by borrowers--and expenses. To date, premiums paid into the mutual insurance fund have been sufficient to cover costs. HUD has reported $79 million net income in fiscal year 1983 after all claims, salaries, and expenses were paid. Mortgage insurance premiums have been insufficient to cover insurance payments and expenses in the general and special risk insurance programs and have required congressional appropriations to maintain solvency. These programs, however, have specific social goals, such as revitalization of older, declining urban areas, and provision for housing higher risk borrowers. Since inception, HUD's single-family mortgage insurance programs have insured about 14 million loans. Roughly 800,000 loans or 6 percent failed.

When insured borrowers stop paying on their mortgages (default) and subsequently lose their homes through foreclosure, the lender then usually conveys the property to HUD, which attempts to resell it. HUD, in turn, pays the lender's insurance claim, consisting of the unpaid mortgage balance and certain reimbursable foreclosure costs. The difference between the proceeds from the sale of the property minus expenses represents a gain or loss to HUD. Between October 1978 and September 1983,

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[1]Actual loss associated with single-family mortgage insurance programs is not available because HUD commingles single-family and multifamily insurance losses.

Figure 1
HUD's Single-Family Mortgage Insurance Request and Approval Process
(Who Does What?)

Local HUD office	Lender	Appraiser	Buyer	Others
Random assignment of appraiser ←	Request for property appraisal (request could also be made by seller or real estate broker)			
Notifies appraiser →	Sends standard forms to appraiser →	Appraises property		
HUD review of appraisal and decision to accept, reject or field review ←	←	Completed forms returned to lenders and HUD		
Conditional commitment issued for accepted appraisals →				
	Completes application with buyer and obtains release for employment and deposit verification and credit report ←		Requests loan under HUD programs	
	Sends release forms to employer, credit reporting agency, and other deposit institutions →			
	Reviews completed forms for accuracy ←			Employer, credit reporting agency, and deposit institutions complete forms
HUD reviews package for completeness and eligibility—accepts or rejects loan ←	Submits loan package to HUD			
Firm commitment issued for accepted loans →				
	Lender and buyer arrange closing ←		Ready to close on loan	
HUD reviews sample of loan packages for completeness ←	Closing documents and completed loan package submitted to HUD. (Under the Direct Endorsement Program, this would be the first submission to HUD)			
Mortgage insurance certificate issued to lender →				

Further, GAO believes that HUD's Property Dispositon review may not be effective in identifying early defaults and the reasons for them. Under this approach, HUD gets involved only after the lender has foreclosed on the property and has evicted the homeowner. However, to complete the foreclosure process could take months or years after the default occurred. Under such circumstances, it is unlikely that HUD will be able to locate former homeowners to determine why the default occurred. (See pp. 23 and 24.)

With regard to randomly verifying data submitted by lenders, HUD said that the cost--both staff and processing time--did not justify the limited protection provided by the requirement. In its response, HUD did not provide any data to support its position. A HUD official told GAO none was prepared. In addition, GAO believes HUD's response is inconsistent with other aspects of its insurance commitment process. Presently, HUD is independently verifying data submitted by property appraisers and credit bureaus but not lenders. Not only are these verification procedures more costly than lender verification, they are also less likely to be effective in preventing fraudulent behavior. HUD stated it relies on its Mortgagee Monitoring Division within its Office of Program Compliance to verify borrower data during the course of their reviews.

GAO continues to believe, however, that because the lender singularly controls all key aspects of the insurance process, additional internal controls are needed to provide assurance that the system is not being circumvented as was done in Camden. According to the Comptroller General's standards for internal control in the federal government, internal controls should be an integral part of the management process used to regulate and guide its operations. Therefore, the HUD staff responsible for making insurance commitment decisions--rather than HUD's Mortgagee Monitoring Division--should have the capability of assessing whether lenders are submitting accurate data. This will give the HUD staff greater assurance that lenders are submitting accurate and complete data prior to the insurance commitment decision. (See pp. 24 and 25.)

HUD also had concerns about a number of other issues GAO raised and offered clarifying information. GAO, as appropriate, made other clarifications or addressed HUD's concerns. (See pp. 26 and 27.)

Contents

ILLUSTRATIONS

ABBREVIATIONS

GAO	General Accounting Office
HUD	Department of Housing and Urban Development
HUD/IG	Department of Housing and Urban Development Inspector General Office
VA	Veterans Administration

HUD property disposition losses exceeded $1.4 billion. (See fig. 2, p. 6.) In fiscal year 1983 alone, HUD lost $414.2 million--an increase of almost $135 million over the prior fiscal year. Recent adverse economic conditions have no doubt been at least partially responsible for the increased losses. However, HUD does not know how much of these losses were due to the "natural" risk associated with its insurance programs and the nation's economic conditions and those losses associated with fraudulent and abusive practices.

CAMDEN, NEW JERSEY, INCIDENT

Reports of an alleged fraudulent housing scheme involving several hundred HUD-insured home loans in Camden, New Jersey, have raised questions about the program's integrity and its vulnerability to fraud and abuse--a condition that could cost the government and ultimately the taxpayers millions of dollars. A series of news media articles in January 1984 alleged that extensive fraud, abuse, and profiteering had plagued HUD's home resale program in Camden. The articles said that

--borrowers' incomes were overstated by falsifying employment verification documents;

--borrowers' credit reports often had substantial omissions;

--borrowers' bad debts were hidden by providing credit bureau agencies with misleading data that resulted in credit reports showing no debts;

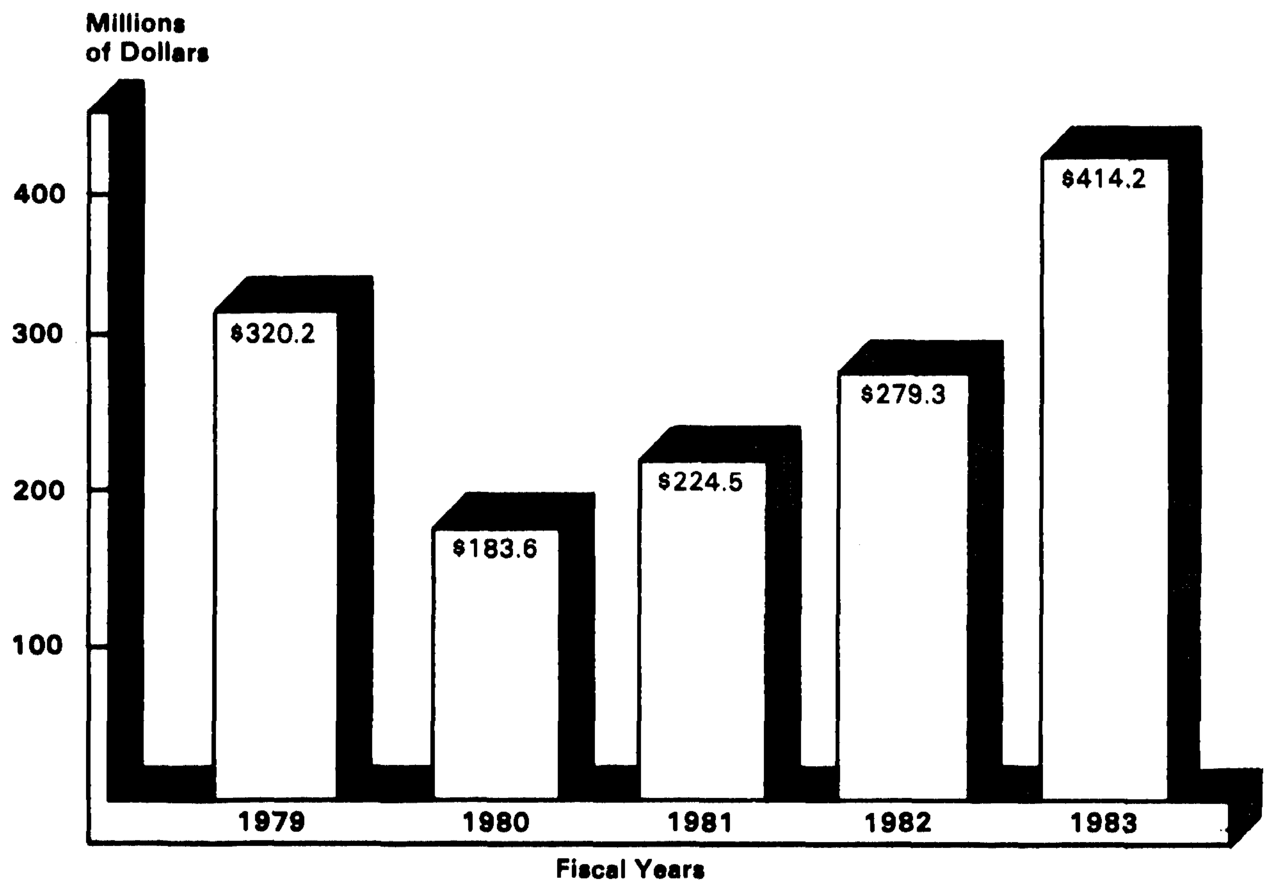
--property defects were hidden to inflate property values; and

--the same real estate company sold a large number of the properties.

In a June 1, 1984, news release, the Secretary of Housing and Urban Development said that a joint task force composed of representatives from HUD's Office of Inspector General (HUD/IG), the Federal Bureau of Investigation, VA, and the Internal Revenue Service had been investigating the fraudulent housing scheme since early 1983 and had identified several hundred potentially fraudulent loans. The news release also indicated that a New Jersey real estate broker had pleaded guilty to two counts of mail fraud and conspiracy in connection with the scheme. Subsequently, two additional persons were convicted.

FIGURE 2

HUD Losses in Disposing of Acquired Properties[a]



[a] The losses represent the difference between the insurance claim paid less the net proceeds from HUD's sale of the acquired property.

Source: Summary of Mortgage Insurance Operations, fiscal year 1979-83, U.S. Department of Housing and Urban Development.

OBJECTIVES, SCOPE, AND METHODOLOGY

Because of the allegations mentioned above, Senators Riegle, Lautenberg, Baucus, and Bradley requested, on January 27, 1984, that we review HUD's multi-unit sales effort of single-family units and provide answers to several specific questions. Because the HUD/IG, the Department of Justice, and the Internal Revenue Service were investigating the Camden multi-unit sales incident, the requestors agreed that we should concentrate our review on HUD's internal control weaknesses that (1) allowed the Camden incident to occur and (2) could also allow other fraudulent and abusive practices to occur in the insurance commitment process.

To identify and analyze internal control processes related to the single-family insurance commitment process, we reviewed the HUD mortgage program regulations and procedures. Furthermore, we expanded our review to include VA and its loan guaranty program since the VA program does basically the same thing as HUD--insure home loans.[2] We visited the HUD office in Camden, New Jersey, and both the HUD and VA offices in Philadelphia and Pittsburgh, Pennsylvania. We met with HUD headquarters officials and HUD/IG staff concerning HUD's insurance commitment process. We also discussed the programs with agency representatives.

Throughout our review, we focused on identifying internal control strengths and weaknesses related to the single-family insurance commitment process. We did not statistically validate compliance with existing procedures at the offices visited. However, we did verify our understanding of the internal control objectives and techniques being used by reviewing selected agency case files.

We made our review between April 1984 and June 1984 and in accordance with generally accepted government auditing standards.

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[2]VA's program usually is referred to as a guaranty program and sometimes an insurance program. In this report, we will refer to it as an insurance program to be consistent with HUD's designation.

CHAPTER 2

HUD'S INTERNAL CONTROL PROCEDURES NEED TO BE STRENGTHENED TO REDUCE THE POTENTIAL FOR FRAUDULENT AND ABUSIVE PRACTICES IN THE INSURANCE COMMITMENT PROCESS

The operating environment for HUD's single-family mortgage insurance program is riskier than the private sector or VA mortgage insurance programs because HUD insures higher risk borrowers and properties in distressed areas and assumes virtually all of the financial risks associated with its insurance programs. For these reasons, HUD should have a sound internal control system that can detect potentially fraudulent or abusive insurance practices.

We found that HUD's current internal control system does not entail adequate procedures to insure prompt identity of loan practices that allow the origination of unsound loans. In contrast, VA has developed an internal control system which has the potential to identify problems in loan origination practices and other adverse trends shortly after they occur.

We believe that certain practices and circumstances resulting in questionable loans can be readily identified and corrected if HUD monitors and investigates loans experiencing default within a short period after loan origination. By capitalizing on "lessons learned" from the small universe of loans going "bad" shortly after origination, HUD will be able to modify local or national insurance commitment procedures, while developing a data base for making policy recommendations concerning insurability criteria. The essential characteristics of this system is a procedure to reverify all causal information, particularly the ability to pay information on the borrower and the property appraisal on loans that experience default within 12 months after origination.

Careful oversight of the loan origination process through measures such as default monitoring will become more critical as HUD implements its Direct Endorsement Program. The program will authorize approved lenders--who shoulder no additional financial risk--to close insured loans without prior authorization by HUD.

AN EFFECTIVE INTERNAL CONTROL SYSTEM CAN MORE EASILY IDENTIFY FRAUDULENT ACTIVITIES

Internal controls are procedures designed to reduce the likelihood of fraud or abuse. If effective, they should, among other things, increase the probability of detecting fraud and abuse and deter undesirable occurrences by requiring the cooperation of a number of people to make fraud possible.

Both HUD and VA insure single-family mortgages. Even though HUD's insured mortgages are generally riskier than VA's, HUD has elected not to verify data submitted by the lender nor determine why mortgages fail within a short period of time after loan origination. In contrast, the VA's internal control procedures encompass both. Since HUD takes greater risk than other insurers, and lenders do not share this risk, the internal control procedures should be more comprehensive.

Why HUD insures riskier mortgages

The potential financial loss/risk that lenders face because of defaulted mortgages is usually a major deterrent to ineffective loan origination practices. However, HUD's single-family mortgage insurance programs essentially remove this risk while encouraging lenders to make loans to poorer, higher risk individuals. Specifically, HUD's insurance programs do the following:

--They allow the homeowner to have considerably more debt as a percentage of total income than the private sector--53 percent for HUD and 38 percent for private insurers. The greater the debt ratio, the less likely it is that the homeowner will be able to weather a financial setback, such as reduced working hours or disability, without defaulting on the mortgage or postponing needed maintenance on the home.

--They allow smaller down payments and longer term mortgages. The smaller the down payment, the greater the loss to HUD if the homeowner stops making the mortgage payment.

--They require the loan to be insured for the life of the loan in contrast to private mortgage insurance, which usually covers only the early years.

--They require the lender to be fully reimbursed for the unpaid loan principal while private insurance usually covers the top 20 percent of the loan and VA covers the top 60 percent. Therefore, lenders have less financial incentive to avoid losses. For example, in news media articles concerning Camden, it was reported that the lender involved had half of its 1982 loan originations fail, yet the lender's president said that he had not inquired about the reasons for so many failures.

--They have mortgage insurance programs for low- and moderate-income families living in older declining urban areas while private insurers and VA do not. Insuring loans in such areas is risky because the property may decrease in value, thus making it advantageous for the homeowner to stop paying on the mortgage and thereby increasing prospective losses when the government sells the foreclosed property.

Regardless of the insurance program, HUD can only lose money if the homeowner stops making mortgage payments and the property has inadequate value to cover the mortgage and foreclosure costs. This insurance risk reaches its greatest level during the years immediately following the insurance commitment. (See fig. 3, p. 11.)

HUD's current internal control system

The HUD office, which makes the insurance commitment, does not independently verify the data submitted by lenders concerning the ability of the borrower to make the mortgage payment, nor does it determine why borrowers stopped paying on their mortgages. Instead HUD concentrates on checking adherence to program requirements and randomly verifying the performance of credit bureaus and property appraisers. Additionally, HUD's central office conducts annual reviews of lenders' loan origination activities. HUD's insurance commitment procedures consist of

--assigning independent private appraisers to determine property value;

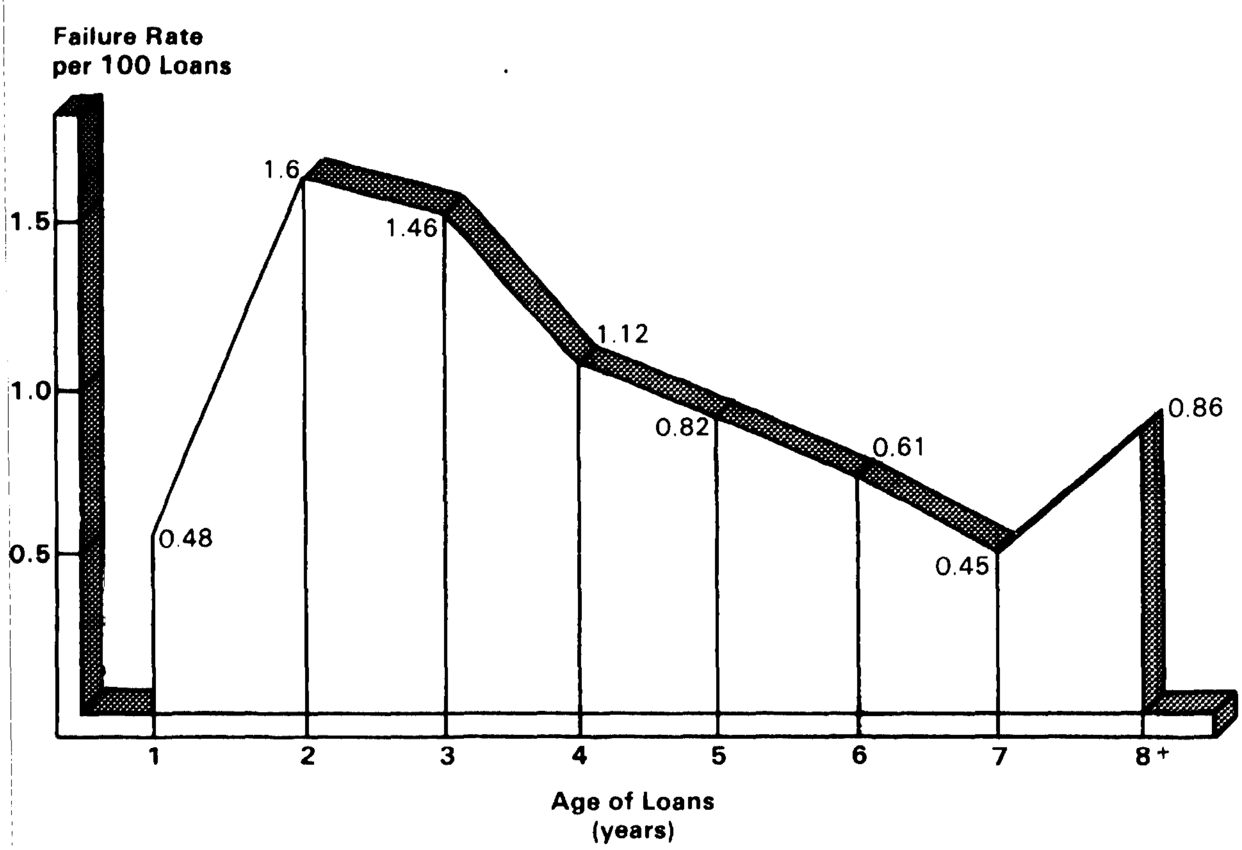
--redoing at least 10 percent of each appraiser's work unless the appraiser has done less than 20 appraisals per month; on the basis of about 735,000 insurance commitments issued in fiscal year 1983, this meant that over 70,000 independent appraisals were done by HUD;

--requiring lenders to verify borrowers' income and assets statements;

FIGURE 3

HUD's 203 Insurance Program Claim Rate By Age of Loan

Claims Paid from January 1957 to December 1981



Source: Bayesian Graduation of FHA HUD Single-Family Home Mortgage Insurance Contracts--Section 203 U S Department of Housing and Urban Development October 1982

--obtaining a second credit report (from another credit bureau) on 5 percent of all insurance commitments to check on the accuracy of the credit bureaus used by lenders;

--examining all the paperwork submitted by the lender before issuing a firm commitment; the analyst's work is checked by a supervisor; and

--examining every tenth loan after loan closing to assure that the paperwork is correct.

Additionally, HUD's Office of Program Compliance conducts loan origination reviews. According to the director, his office has a staff of 22 specialists who are assigned to monitor the loan origination activities of 6,000 lenders. The specialists are stationed in 16 locations throughout the United States and report directly to HUD headquarters. Through July 1983 only six specialists were assigned to mortgage insurance reviews with the remaining specialists being assigned to other program reviews, such as HUD's rehabilitation loans. Because HUD is implementing the Direct Endorsement Program, which increases insurance risks, the entire staff since 1983 has been cross-trained, and the review emphasis has been placed on mortgage insurance programs.

The director added that during the reviews, the specialist will examine between 15 to 25 files of in-process and closed insurance commitment cases. After returning to the office, the specialist will obtain independent employment verifications on one-third of the cases reviewed. If the lender is involved in the Direct Endorsement Program, all data will be verified.

<u>VA's internal control system relies on monitoring lender activities</u>

VA has several internal control procedures similar to HUD's, such as assigning independent appraisers to determine property value, independently verifying 10 percent of the property appraisals, and relying on lenders to verify borrowers' income and assets statements independently. However, VA also independently verifies 10 percent of the borrowers' income and assets statements; that is, it sends verification statements directly to employers and banks. According to the loan guaranty officers in Philadelphia and Pittsburgh, this allows VA to determine if the lender is doing an adequate job of verifying borrowers' statements.

As part of the insurance commitment monitoring process, VA's procedures require determination of the reason every mortgage goes into default (those reported by the lender between 60 and 105 days after payments stop). For those that go into default during the first 3 months after loan origination, the entire insurance commitment process is redone to determine if (1) lender or borrower fraud existed or (2) VA insurance commitment standards were violated. If adverse trends are noted, the local office will develop and apply appropriate control procedures. For instance, the Philadelphia VA office noted that one lender seemed to have a high number of first-year defaults. As a result, VA altered its insurance commitment process by independently verifying all documents submitted by the lender.

The Philadelphia and Pittsburgh loan guaranty officers both emphasize that default monitoring acts as an effective deterrent of fraudulent activities. Furthermore, according to the chief of mortgage credit at the Philadelphia VA office, default monitoring provides several advantages over merely sampling insurance commitment applications:

--Adverse trends are more easily identified since all "bad" loans have to pass through the screening process.

--VA credit examiners can be evaluated by comparing the number of insurance commitments made to the number of "bad" commitments identified.

--Insurance commitment procedures can be continuously updated to prevent lenders, sellers, and real estate brokers from "beating the system."

The chief of mortgage credit also said that the Philadelphia VA office reviews any default in the first 12 months after origination instead of just the first 3 months. He said that a 12-month system affords VA greater protection against fraud or poor loan insurance commitment practices than one that looks only at defaults occurring within the first 3 months after loan origination.

INSURANCE COMMITMENT MONITORING IS A CRITICAL COMPONENT TO EFFECTIVE RISK MANAGEMENT

Monitoring of mortgages that go into default within a short period of time after origination would allow HUD to evaluate how well its insurance commitment system is doing while also allowing the local HUD office to adjust to changing operating conditions. We believe such a monitoring system could have assisted in disclosing alleged fraudulent activities in Camden, New Jersey.

Monitoring can result in better internal control procedures

A system directed to a relatively small universe of defaulted loans could help detect and analyze trends that cause insurance losses and provide the basis for improving existing controls. Most insured mortgages do not result in default, and if a homeowner defaults after being able to make payments for 12 months, the default risk would unlikely have been due to the insurance commitment process. Likewise, if an attempt is being made by lenders, borrowers, sellers, and/or real estate brokers to obtain insurance through deceptive means, the default would likely occur shortly after the loan is made and insurance obtained. For example, according to the indictment leading to a conviction in the Camden fraud scheme, the real estate broker made the first 3 monthly loan payments to avoid the appearance of a high default rate on HUD-insured loans. On the basis of our review of Camden loan files, we estimated that the broker's "gain" was reduced by about $900--not enough to deter the fraud. However, if the broker had to make 12 payments, the gain would have been reduced by $3,600. Therefore, continuous payments would reduce gain, a highly unlikely characteristic of a person intending to commit a fraud.

Insurance commitment monitoring provides a method of determining how well the insurance commitment system is working:

--HUD loan examiners are given considerable latitude in approving insurance commitments. Insurance commitment monitoring would allow HUD to evaluate its loan examiners' performance and weaknesses. Currently, loan examiners do not know how many of their insurance commitments fail or why.

--HUD, through congressional and administrative mandates, has made several policy decisions about the kinds of borrowers whose mortgages are insurable. For example, a borrower without a credit history is considered to be an insurable risk. Insurance commitment monitoring would allow HUD to evaluate these policies to determine if the policies should be modified.

--HUD cannot now detect fraud and abuse in the insurance commitment process if all the paperwork is properly filled out. Insurance commitment monitoring would allow HUD to concentrate fraudulent trends through a narrow "channel" since borrowers have to stop paying on the mortgage if the government is to lose any money. For example, HUD made over 700,000 insurance commitments in fiscal year 1983 but had only 27,000 insurance claims. By concentrating monitoring on the defaulted loans, fraudulent trends are more easily detected.

--Failure rates vary substantially by location. Insurance commitment monitoring would allow HUD to adopt specific local internal control techniques. As a result, the insurance commitment process would not have to be over-controlled.

According to the Director, Office of Program Compliance, defaults within a short period of time after loan origination are a "red-flag" that potential problems exist in the insurance commitment process. However, he said that his office does not have the necessary data to identify these situations and his reviewers are basically "shooting in the dark" when they audit a lender's loan origination activities. The director also said that every time his office audits a good lender, he has fewer resources to audit problem lenders.

In summary, an insurance commitment monitoring system provides the means for identifying risks associated with insurance operations. How this fits into a closed-loop decision process is illustrated in the following schematic. (See fig. 4 p. 16.)

Insurance commitment monitoring
how would it work?

The key to effective insurance commitment monitoring is for HUD to obtain data that would indicate potential adverse trends affecting the insurance commitment process. After identifying such trends, additional or modified internal controls could be put into effect. For example, if default monitoring disclosed that several homeowners did not have the income that they alleged at the time the loan was originated and that certain lenders were involved, HUD could initiate a 100-percent check of all income verification documents submitted by those lenders.

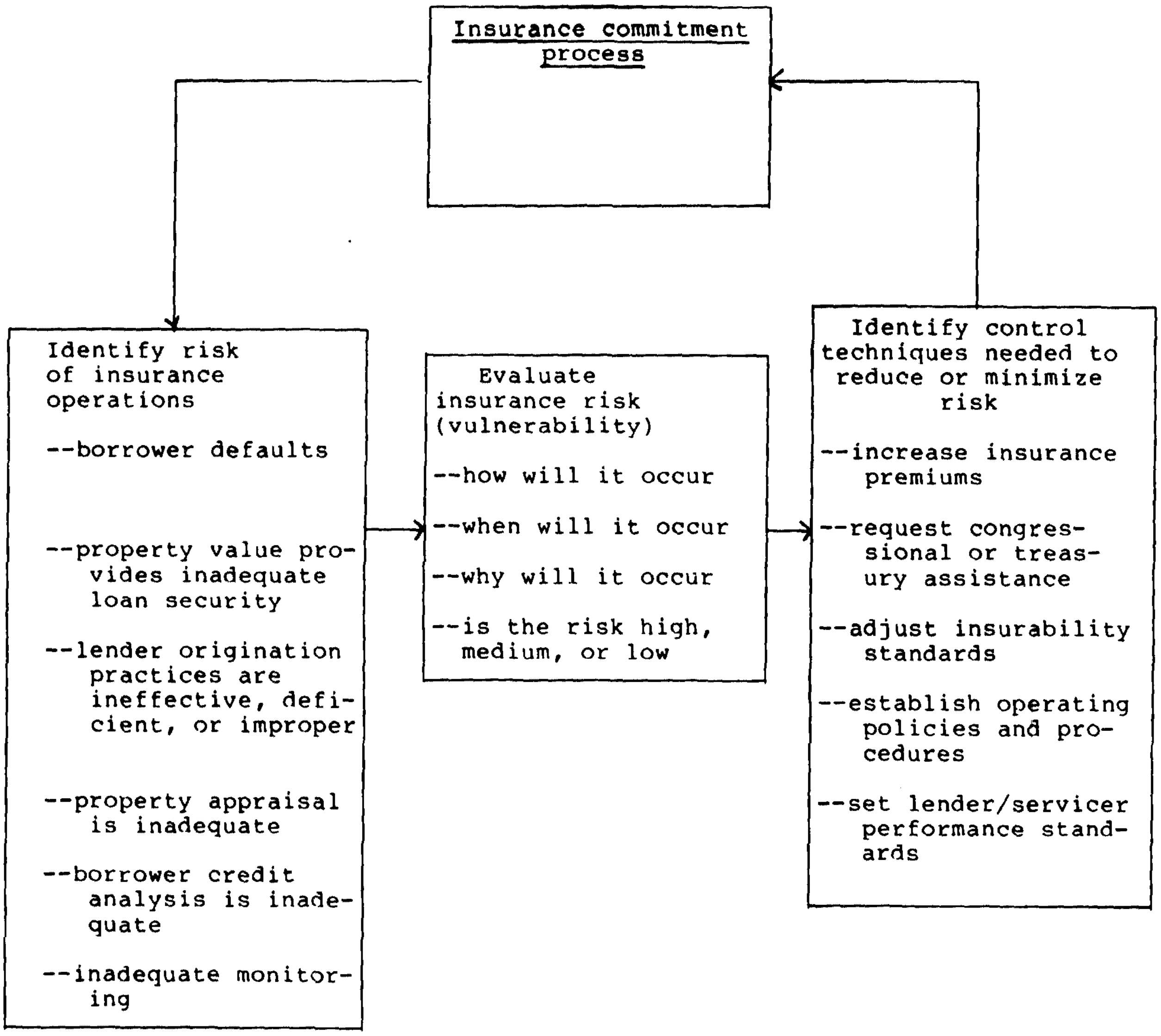
HUD does require lenders to report the current status of each default delinquent 90 days or more to HUD headquarters in Washington, D.C. However, the data do not relate defaults to the date of loan origination.

We believe for insurance commitment monitoring to be effective, HUD must

--require that lenders notify the local HUD offices about all homeowners who default shortly after loan origination--possibly up to 12 months;

Figure 4

Mortgage Insurance Closed Loop Decisionmaking Process



Source: GAO constructed.

--require lenders to report the initial default date, the reasons for the default (if known), and what efforts the lender has made to resolve it; and

--attempt to contact the borrower to determine the reasons why he or she stopped making house payments.

On the basis of data provided and the insurance commitment files[3], HUD staff would attempt to determine the factors leading to the default and keep records of these factors to identify adverse trends. Once an adverse trend is detected, the local HUD office could revise its internal control procedures. For example, according to the loan guaranty officer at the Philadelphia VA office, it found that although some loan origination credit reports showed no credit history, borrowers who defaulted had extensive obligations. As a result, the VA office began independently verifying credit reports showing no established credit history.

In addition, if HUD found several cases where no mortgage payment was ever made and the lender has been unable to contact the borrower, it would be possible that the buyers were "straw-buyers"--they either did not exist or the homeowner was not the buyer who applied for the loan. Several such cases allegedly occurred in Camden. By attempting to contact these buyers at their place of employment or through credit checks and interviewing other homeowners in the neighborhood, HUD could determine if the buyer existed.

Insurance commitment monitoring in Camden

One of the key components of insurance commitment monitoring is determining why borrowers--who only a short time previously were determined to have the ability to make the monthly house payment--stopped making the house payment. In attempting to determine why, certain adverse conditions would have readily been apparent in Camden:

--Borrowers had extensive debt obligations, yet credit reports in the insurance commitment file showed no previous credit history.

--Borrowers had less income than shown in the insurance commitment file, yet the borrowers did not report any change in employment status.

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[3]The files would have to be kept at the local HUD office for 12 months. Currently, the files are sent to HUD headquarters shortly after the insurance certificate is issued.

--Major property deficiencies were not noted by the appraiser at the time of insurance commitment.

--Properties were previously owned by nonhomeowners (that is, speculators or investors).

Evaluating "why" the above inconsistencies exist would have shown that

--false employment information was provided by the borrower, real estate broker, or "supposed" employer;

--credit reports showed no credit history because the borrower, real estate broker, or lender provided misleading information to the credit bureaus such as social security numbers of children; and

--defective property conditions were concealed by the seller.

Corrective measures could have included (1) sampling or a 100-percent HUD-verification of data provided by the lender, (2) questioning all credit reports showing no previous credit history, and (3) HUD appraising most if not all properties previously owned by nonhomeowners.

Some of the above corrective measures may have nationwide implications. As stated previously, HUD does not independently verify the borrower's employment or credit history as part of the insurance commitment process. If HUD did this on a sampling basis, it would be more difficult to perpetuate fraud. For example, by verifying employment, HUD would require the fraudulent scheme to involve an employer who is willing to provide falsified data. In Camden this did occur. In other cases parties other than the employer provided falsified employment data.

Additionally, HUD needs to implement additional internal control techniques whenever a credit report showed no previous credit history and speculators are involved. Given the apparent rarity of a "no credit history" report--Pittsburgh's HUD office reported receiving only 5 percent in its insurance applications--such reports should be considered suspect. HUD procedures, however, do not treat a no credit history report as a suspicious indicator. HUD simply accepts the credit report and does not question its accuracy. In cases such as these, the buyers may be asked by the lender to supply statements that they used only cash for all purchases.

We believe that a no credit history report should act as an early warning sign of the potential for fraud. In 25 of 29

Camden insured loan files we reviewed which had credit reports, the credit report showed no previous credit history. Other information could also be disclosed by the credit report and should serve as warnings to the HUD reviewer. For example, in one case we reviewed, the credit bureau had contacted the potential home buyer and found that the person was employed full-time and also received monthly welfare payments for dependent children. This should have served as a warning to the HUD reviewer because welfare recipients usually do not work full-time.

According to newspaper articles concerning Camden, speculators (1) bought low-priced housing from HUD, the city of Camden, and individual homeowners, (2) made minimal repairs to the properties, and (3) sold them for substantial gain.

Prior to the Camden incident, HUD did not have an internal control procedure that required that its valuation section be notified about HUD properties that were sold. Subsequently, HUD has implemented procedures to identify properties it previously owned. We believe this is a very important control to provide an adequate audit trail and documentation concerning these properties. Nevertheless, the controls apply only to properties that had previously been held by HUD. We believe the "red-flag" situation applies to any property recently purchased for speculative purposes not just HUD-held property. HUD should consider independently appraising, inspecting, and verifying all repair work done on these properties.

The HUD/IG and HUD field personnel told us that a problem exists with the use of VA's appraisal process. According to agreements between HUD and VA, each will accept the other's appraisals without question and without documentation. A HUD/IG official said that speculators knew VA would appraise a property "as is" with very few repair requirements. In 3 of the 32 Camden cases we reviewed, the VA appraisal was accepted by HUD and the mortgage was insured under HUD's 221(d)(2) program, which allows home buyers to pay a lower down payment than HUD's conventional insurance program. As a result, the mortgage insurance covers virtually the entire sale price of the home.

Faced with faulty repairs, inflated values, and no equity investment in the home, a buyer may default if a major repair is required or loss of income occurs. Thus, appraisal accuracy becomes very critical in these cases. Since HUD is taking additional risks in insuring these mortgages, at a minimum, HUD should obtain a copy of the VA appraisal when it is used in making insurance commitments.

Finally, good internal control procedures require that all pertinent data be used in evaluating the agency's potential risk and that adequate documentation exist to support risk decisions.

Therefore, each insurance commitment file should have the documentation concerning the borrower's ability to pay and the justification for the property value. Nevertheless, when VA appraisals are used, HUD does not receive the appraisal documentation. As a result, no data exist to support the property value. Additionally, when a previously HUD-owned property is involved, HUD does not have the necessary data to evaluate and compare the new value with prior property inspections and appraisals.

HUD'S DIRECT ENDORSEMENT PROGRAM NEEDS BETTER INTERNAL CONTROLS

HUD is now passing all of the insurance commitment responsibility to lenders, but lenders still will not have any additional financial risk. As a result, HUD is setting up monitoring procedures unique to this concept. The proposed procedures, while moving in the right direction, still lack the necessary components to adequately monitor insurance program activities.

Direct Endorsement: lender commits HUD without prior approval

The Direct Endorsement Program is intended to simplify and expedite the process by which lenders secure mortgage insurance endorsements from HUD. According to the Director of the Office of Program Compliance, direct endorsement also is in keeping with the administration's policy of having greater private sector involvement. Under Direct Endorsement, the lender commits HUD to insure the mortgage loan without prior HUD review or approval.

HUD looks to the lender as the focal point for the Direct Endorsement Program. According to the program's handbook, the lender assumes the following responsibilities:

--The compliance with HUD instructions, coordination of all phases of underwriting, and the quality of decisions made under the program.

--The review of property appraisal reports, compliance inspections and credit analysis performed by staff and nonstaff personnel to assure reasonableness of conclusions, soundness of reports, and compliance with HUD requirements.

--The decisions relating to the acceptability of the appraisal, the inspections, the buyer's capacity to repay the mortgage, and the overall acceptability of the mortgage loan for HUD insurance.

--The monitoring and evaluation of the performance of staff and nonstaff personnel used for the Direct Endorsement Program.

The Direct Endorsement Program was designed to make the lenders cognizant of HUD endorsement requirements and the responsibilities involved in originating and closing mortgage loans without prior HUD review. If the mortgage loan meets HUD's criteria, HUD will endorse the mortgage for insurance. The resulting insurance contract is incontestable except in cases of fraud and misrepresentation by the lender.

The Direct Endorsement Program, however, provides lenders with considerable latitude in approving insurance commitments with virtually no risk to themselves. HUD has a coinsurance program that provides similar latitude but involves financial risk to the lender. Under that program, few coinsurance mortgages were written; conversely, HUD expects half of the fiscal year 1984 insurance commitments to be made under the Direct Endorsement Program.

HUD control of direct endorsements

HUD has elected to control the direct endorsement process by collecting data on loans and reviewing the files. A HUD clerk reviews each insurance commitment file submitted by the lender to assure that the file contains all pertinent data such as the credit report and property appraisal, and that the data were properly prepared. After the review, the file data are entered into a computer. According to HUD clerks in Philadelphia and Pittsburgh, it takes an average of one-half hour to input all the data. Based on the computer analysis,

--the borrower is rated in one of five categories ranging from very low risk to very high risk, and

--the property appraisal is rated against the expected property value.

On basis of the above analysis, HUD staff conduct post-endorsement technical reviews. HUD's review appraiser examines each appraisal and gives it a rating of "good, fair, or poor." The reviewer then visits 10 percent of the appraised properties, concentrating on appraisals with the most unsatisfactory ratings. HUD's mortgage credit examiner scans certain data in each insurance commitment file. Further, 10 percent of all cases received are completely reviewed. Cases are selected for detailed review through the computer system credit rating of the borrower's and the examiner's cursory file review. After completing the review (cursory or detailed), the examiner rates the case good, fair, or poor--if continuously poor, the lender could be barred from the Direct Endorsement Program. Except for field reviews of appraisals, HUD reviewers do not independently verify data submitted by lenders.

HUD will need to determine why direct endorsement mortgages fail

Although the insurance commitment file submitted by lenders includes considerable data on each insurance commitment, HUD still will not know the reasons mortgages failed or are failing. Without such knowledge, appropriate internal control techniques cannot be devised or modified to handle local risk conditions.

Under direct endorsement, HUD's internal control procedures provide for determining if lenders made the correct insurance commitment decision based on data provided by the lender except that HUD independently verifies 10 percent of the property appraisals. We believe that this approach is less than optimal because of the following:

--No independent verification is made on the data provided by the lender concerning the borrower's ability-to-pay.

--The system lacks a tie between default monitoring and the data obtained for the insurance commitment. Without such a tie, HUD cannot adequately identify which risk factors have caused mortgage defaults and failures and whether the insurance commitment process should be changed or modified.

Therefore, while HUD will obtain considerable data about direct endorsed insured mortgages, HUD will still not have necessary data to modify its procedures based on local risk factors such as substantial speculator activity--factors which could make the insurance programs susceptible to fraud. Furthermore, without risk evaluation HUD will be unable to determine if certain insurance criteria should be changed. For example, now the borrower can have up to a 53-percent debt-to-income ratio. A default trend evaluation may show that borrowers right at or near the 53-percent level have an extremely high failure rate. If identified, HUD could elect to reduce the debt-load criteria.

CONCLUSION

HUD assumes virtually all of the financial risks associated with its single-family mortgage insurance programs. HUD is responsible for evaluating and controlling these risks. Therefore, an adequate risk management system should encompass the necessary data to identify and evaluate such risks. We believe that such a risk management system requires monitoring at the point where HUD is most vulnerable to loss--where the homeowners stop paying on their mortgages--and identifying the appropriate internal control procedures to be applied to the insurance commitment process. These procedures will vary by location and insurance program. Without such a monitoring system, HUD has less flexibility in designing an appropriate internal control system and increases the possibility that fraudulent practices will go undetected.

RECOMMENDATIONS TO THE SECRETARY OF HUD

We recommend that the Secretary of HUD develop a monitoring procedure to identify mortgages that default within a specified time after loan origination (perhaps all defaults during the first 12 months) so that alleged fraudulent loan practices such as those being investigated in Camden, New Jersey, are identified and evaluated. As appropriate, modifications should be made either to the local or national insurance practices.

Additionally, we recommend that HUD revise its insurance commitment procedures to

--verify, by sampling, data submitted by lenders;

--independently verify credit reports that show no credit history;

--independently verify appraisals involving investor-owned properties if the investor had recently purchased the property; and

--insure that VA property appraisal data are included as part of the file documentation when HUD uses it in making the insurance commitments.

AGENCY COMMENTS AND OUR EVALUATION

HUD provided us with written comments on our draft report. (See appendix III.) HUD said that it is modifying its Single-Family Default Monitoring System so that it can be used with the Computerized Home Underwriting Monitoring System. HUD said that it will be able to capsulize the appraisal and credit data for each loan transaction after the system is completed. HUD estimated that it will be the middle of 1986 before the systems will be operational and able to provide data necessary to monitor insurance-in-force and specifically, defaulted mortgages. Because the system is not fully developed, we are not in a position to determine if HUD's modified system will provide the data necessary to effectively monitor mortgage insurance activities.

To respond to our recommendations during the interim period, HUD said that it is requiring its field offices to review early defaults (first 6 months after loan origination) to determine the causes for such problems. Additionally, HUD will (1) identify defaults by year of origination and lender, (2) review recently closed loans to ensure compliance with underwriting requirements, and (3) on a quarterly basis, analyze claims for loans insured from 1982 and each year thereafter by loan characteristics (investor, refinance, etc.) and length of time from endorsement to claim by lender and field office.

All these efforts, if properly implemented, should assist HUD in identifying adverse loan origination trends. However, we reviewed HUD's January 31, 1985, implementing instructions to its field offices and believe that the instructions do not ensure that HUD will be notified immediately of loan defaults. For example, HUD is requesting that its field offices review data provided by lenders during the processing of HUD's homeowner assistance (Assignment) program to determine if the mortgage default occurred in the first 6 months after loan origination. If it did, then the case is to be referred to the Mortgage Credit Branch for a possible review. Under the assignment program, HUD, if requested by the lender and the homeowner, can take over the mortgage from the lender to give the home owner additional time to avoid foreclosure. The problem with using this process as a vehicle to identify fraudulent and abusive insurance practices is that HUD's assignment program is voluntary. Therefore, it is unlikely that lenders and homeowners will request HUD's assistance under the assignment program if they obtained the loan under fraudulent conditions.

In addition, HUD has directed its Property Disposition Branch to review the forms submitted by lenders as part of the insurance claims foreclosure package to identify early mortgage defaults. All early default cases identified are to be referred to the Mortgage Credit Branch. The Mortgage Credit Branch, in turn, will request the insurance commitment file from Washington, D.C., and determine if the information contained in the original mortgage application was essentially correct and to learn, if possible, why homeowners were unable or unwilling to make their payments. Under this approach HUD gets involved only after the lender has <u>foreclosed</u> on the property and has evicted the homeowner. However, to complete the foreclosure process could take months or years after the default occurred. Under such circumstances, it is unlikely that HUD will be able to locate former homeowners to determine why the default occurred.

Therefore, we believe that whenever a default occurs within a specified time after loan origination, HUD should require lenders to submit data to the local office immediately. This would allow HUD to attempt to contact the homeowner at that time to determine why the default occurred.

With regard to randomly verifying data submitted by lenders, HUD said that the cost--both staff and processing time

--did not justify the limited protection provided by the requirement. Instead, HUD stated that it relies on its Mortgagee Monitoring Division within its Office of Program Compliance to verify borrower data during the course of their reviews. We continue to believe, however, that because the lender singularly controls all key aspects of the insurance process, additional internal controls are needed to provide assurance that the system is not being circumvented as was done in Camden.

We discussed HUD's mortgagee monitoring reviews on page 12. As shown, HUD's Mortgagee Monitoring Division has 22 specialists who periodically visit and monitor loan organization activities of 6,000 lenders. As HUD indicated in its comments, these specialists verify borrower data during their visits. However, according to the Comptroller General's standards for internal control in the federal government, internal controls should be an integral part of the management process used to regulate and guide its operations. Therefore, the HUD staff responsible for making insurance commitment decisions--rather than HUD's Mortgagee Monitoring Division--should have the capability of assessing whether lenders are submitting accurate data. This will give the HUD staff greater assurance that lenders are submitting accurate and complete data prior to the insurance commitment decision.

Concerning HUD's contention that the cost of verifying data submitted by the lender exceeded the benefits, in its response, HUD did not provide any data to support its position. A HUD official told us none was prepared. In addition, we believe HUD's response is inconsistent with other aspects of its insurance commitment process. Presently, HUD is independently verifying data submitted by property appraisers and credit bureaus but not lenders. Not only are these verification procedures more costly than lender verification, they are also less likely to be effective in preventing fraudulent behavior.

According to HUD personnel in Pittsburgh, verifying property appraisals cost about $20 per appraisal plus mileage, and verifying credit reports costs $19 per report. In contrast, VA personnel in Pittsburgh estimated that lender verification cost about $4 per insurance application. Using VA's $4 figure and applying it to 10 percent of HUD's 346,340 insurance commitments in fiscal year 1984 results in a cost figure of about $140,000. To put the $140,000 cost in proper perspective, it should be noted that in fiscal year 1984 HUD insured 346,340 loans valued at $18.7 billion and lost $540 million in disposing of 31,985 properties acquired through foreclosure--borrower stopped paying on his/her mortgage. Even if HUD prevented only nine bad loans from being written because of lender verification (.03 percent), every dollar spent on verification would have been recovered through reduced foreclosure losses. (This calculation is based on the average HUD foreclosure loss of $16,900 times 9 loans, which equals about $150,000 as compared to the verification cost estimate of $140,000.)

According to HUD regulations, 10 percent of its property appraisals are to be field reviewed--HUD staff physically visits the property--and 5 percent of the credit reports are to be independently checked by another credit bureau. The latter is done to determine if the credit bureau submitting the original credit report had accurate and complete credit data. It should be noted that HUD already has several internal control checks on property appraisals. Specifically, HUD assigns the appraiser, does so by random selection, and prohibits the appraiser from having any financial investment in the appraised property. Additionally, the appraiser by himself cannot perpetuate the fraud because he does not control the other aspects of the insurance commitment process.

As pointed out in the report, the government can only lose money if the borrower stops paying on the mortgage. Therefore, the crucial data elements are those supporting the borrower's ability to pay the mortgage payment. These data elements are controlled by the lender. The lender is the one that has the face-to-face contact with the borrower and requests verification of the borrower's income and assets. Therefore, we continue to believe that HUD's field offices should verify lender data to prevent or reduce the possibility of situations such as occurred in Camden.

HUD agreed with our recommendation that credit reports showing no credit history should be carefully reviewed to determine that the borrower did not, in fact, have a prior credit history. HUD said that appropriate instructions will be issued. With regard to our recommendation that HUD independently verify appraisals of investor-owned property, HUD contends that its property appraisal procedures are adequate except that additional steps are being taken on those properties that had previously been owned by HUD. We believe that HUD should use the same procedures for all investor-owned properties, not just those previously owned by HUD. The same fraudulent and abusive conditions could exist for both types of property in which the investor buys the property for a low price, performs marginal or cosmetic repairs on it, and sells it for a substantial profit. HUD procedures should, therefore, strive to reduce the risk of inflated property values. This could be done by identifying all properties that had recently been purchased by investors and independently verifying their values.

Concerning our recommendation that HUD obtain VA property appraisals when those appraisals are used in making insurance commitments, HUD said that the claim rate associated with VA-appraised properties was not substantially different from that for HUD-appraised properties. They also state, that it would be very difficult to justify the need for one government agency to duplicate the work of another. We are not asking HUD to redo the appraisal but only to obtain the appraisal document from VA when it is used in making the insurance commitment. By obtaining the appraisal document, each insured file will more fully support HUD's justification for issuing the insurance commitment. No additional cost should be incurred.

Finally, HUD mentioned in its response that we had removed portions of the report with which it disagreed. For example, after discussing the draft report with HUD officials informally, we made changes to clarify the report so that a reader would not assume that HUD's fiscal year 1983 losses of $414 million were due only to fraudulent and abusive practices. (See pp. 3 and 5.) Additionally, we included in this report that fiscal year 1983 insurance premiums exceeded losses and administrative expenses by $79 million. (See p. 3.)

United States Senate

WASHINGTON, D.C. 20510

January 27, 1984

The Honorable Charles A. Bowsher
Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

Please find enclosed a copy of two recent stories that appeared in the Philadelphia Inquirer. As you will note from reading these stories, serious problems exist in the management of the Office of Single Family Development Division and the Single Family Property Disposition Division at the Department of Housing and Urban Development (HUD). After reviewing many of the documents associated with these programs in Camden, New Jersey, we are convinced that a thorough investigation of the entire program is necessary. Since your office, in response to an earlier request, has a review of HUD's Property Disposition program already underway, we request that that investigation be intensified to address the specific problems uncovered in Camden, N.J. and provide answers to the following questions.

1. How many homes has HUD sold in the past three years as part of their multi-unit sales effort? What was the average price of those homes?

2. What was the average resale price for homes sold by HUD in the past three years as part of their multi-unit sales effort and purchased by individuals? What was the average listed cost of improvements made for those homes?

3. How many of the homes sold by HUD in the past three years as part of their multi-unit sales effort have been federally insured? How many of those homes are currently in default? How many of those homes are currently in foreclosure or have gone through foreclosure?

4. What problems exist in the Camden, New Jersey office of HUD that allow such widespread fraud to exist and exorbitant profits to be made on the resale of HUD owned and HUD insured homes?

5. Do the problems that exist in the Camden, New Jersey office of HUD exist in other regional HUD offices?

6. Have there been any benefits resulting from the HUD multi-unit sales effort?

Page two
January 27, 1984
The Honorable Charles A. Bowsher

7. What alternatives to a multi-sales program exist that will assure that individuals and families are able to purchase decent government owned housing at a fair price?

We appreciate your attention to this matter. It is our understanding that both the Department of Justice and the Office of Inspector General for HUD are investigating the specific problems in the Camden area. We believe, however, that it is essential that your review include an evaluation of the overall multi-unit sales program efforts at HUD. We would appreciate members of your staff contacting us to discuss the specific issues involved in this review.

Sincerely,

Donald W. Riegle
Ranking Minority Member
Subcommittee on Housing and Urban Affairs

Frank R. Lautenberg

Max Baucus

Bill Bradley

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

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

APR 5 1934

Don Campbell, Minority Staff Director
Subcommittee on Housing and
Urban Affairs
Senate Committee on Banking,
Housing and Urban Affairs
Room 548, Dirksen Building
Washington, D.C. 20510

Dear Mr. Campbell:

During our prior meetings on Senators Riegle, Lautenberg, Baucus, and Bradley's joint request dated January 27, 1984, for a review of HUD's management of its single-family bulk sales program, we tentatively agreed on the scope of the work our office would do to satisfy this request. We said we would let you know our definite plans at a later date. Subsequently, we have discussed the request internally as well as with HUD Office of Inspector General and related program officials and have decided, if agreeable with you and the staff of the other Senators, to:

--maintain contact with the HUD Office of Inspector General staff who are also looking into the bulk sales program to avoid duplication and to make suggestions to them as we feel appropriate; and

--provide the Senators a written report by late summer on the generic underwriting items which we believe could have caused the problems observed in HUD's bulk sales as well as regular single-family disposition program.

The seven specific generic underwriting problems we plan to address in our report are listed in the attachment to this letter.

We would be glad to further discuss the scope of our work on this request if necessary. If not, we will periodically brief the Senator's staff on our contacts with the HUD Office of Inspector General staff and the results of our work as we progress. We look forward to working with you and the staff of the other Senators on this project.

Sincerely yours,

William J. Gainer
Group Director

bcc: Mr. Gazda
Mr. Johnson
Mr. Komykoski
Mr. Toner

Attachment

Potential Underwriting Problems

1. No tie between property disposition and the insurance commitment section.

2. No random sampling of application packages submitted by lender to verify if the data provided was accurate.

3. Credit reports which report no credit activity are not independently checked for validity.

4. No effective system is in place for HUD to check on its underwriting activities after the insurance commitment has been made.

5. Lending risk is borne almost entirely by HUD. Lender has little to lose if the mortgage fails.

6. HUD treats all insurance risk equally. Higher risk programs such as Section 221(d) (2) have no additional safeguards against the increased risk.

7. No system in place to determine reasons for substantial decreases in property value from loan origination to foreclosure.

These kinds of questions are not ordinarily addressed in HUD's reviews of individual mortgage--rather these questions relate to problems inherent in HUD's present procedures.

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

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

MAR - 5 1985

Mr. J. Dexter Peach
Director, Resources, Community and
Economic Development Division
United States General Accounting
Office
Washington, DC 20548

Dear Mr. Peach:

Your letter of October 26, 1984, addressed to the former Assistant Secretary Barksdale transmitting a proposed report to the Congress entitled: "Strengthening Internal Controls over Single Family Mortgage Insurance Programs", has been referred to me for reply.

This Department places highest priority on the integrity of its single family programs. For that reason, what occurred in Camden, New Jersey, is as distasteful to us as it is to the American public.

Before responding to the specific recommendations, I believe that the report should be placed in its proper perspective. Since the type of problem (i.e. fraud) mentioned in your report usually surfaces shortly after origination, it follows that HUD's first year claims should especially reflect this problem. In 1981 and 1982, HUD experienced a relatively high percentage of first year claims (approximately .70 percent of mortgages insured during those years). However, new data for 1983 indicate a dramatic drop in first year claims (down to .17 percent). In fact, the 1983 percentage is the lowest for the 14 years analyzed (1970 - 1983).

While this data indicate that over 99.8 percent of the loans originated in 1983 were not encumbered with fraud-related problems, in no way, does it minimize our concern for the Camden situation. To improve mortgage quality, HUD embarked on a major automation effort in 1979. During the last two years, two parts of that initiative were installed. In addition to the Direct Endorsement Tracking and Review System (DETRS) to which GAO alluded in their report, Phase I of the Computerized Homes Underwriting Management Systems (CHUMS), which automated the appraisal process, was installed last summer. A new feature recently added to that system enables HUD to identify sales of HUD-owned properties prior to any reinsurance. Instructions have been issued to all field offices requiring field review of the appraisal in any case where the new value exceeds the HUD sales price by more than 10 percent. Another enhancement in development will enable HUD to automatically identify defaults by year of origination (early defaults) and originating mortgagee.

Although the entire automated system should be in place by the middle of 1986, we have taken immediate interim steps to avoid future problems of this type. On a manual basis, field offices now review early defaults to determine the causes for such problems. In addition, Headquarters reviews statistical data on defaults and originations for selected field offices monthly to identify possible patterns of early default by originating mortgagee. We also have established a review procedure of recently closed loans to ensure compliance with HUD underwriting requirements. Finally, on a quarterly basis, we have begun analyzing claims for loans insured from 1982 and each year thereafter by loan characteristics (investor, refinance, etc.) and length of time from endorsement to claim by originating mortgagee and field office. When our automated system is fully installed, this effort will be greatly facilitated.

Since we understand that GAO has modified their proposed report to remove portions with which we strongly disagreed, I will proceed with answering the recommendations in the order that they are presented in the report.

Recommendation Number 1: The Secretary of HUD should instruct local HUD offices on a sampling basis, to verify data submitted by lenders.

Reply: HUD implemented a similar requirement in the mid-seventies. Field office response indicated that the cost (both staff and processing time) did not justify the limited protection provided by the requirement. Instead, HUD relies on its Mortgagee Monitoring Division to verify borrower data during the course of their reviews. During a fiscal year, about 800 mortgagee reviews are completed with emphasis given to high volume lenders and field office referrals. If a field office becomes suspicious about a lender's practices, a review can be conducted quickly.

Recommendation Number 2: The Secretary of HUD should instruct local HUD offices to independently verify credit reports which show no credit history.

Reply: As you note, HUD does not consider the lack of the use of credit as a negative factor in the borrower analysis. While we are confident about the quality of credit reports received from established bureaus, we share your concern about reports from bureaus where no favorable experience has been developed. In this regard, we will remind field offices to focus their back-up verifications on credit reports showing no credit history that were done by bureaus without an established track record. In addition, in cases where field offices are suspicious of borrowers with no credit history (i.e. P.D. sales, etc.), instructions will be issued to have staff attempt to verify data independently.

Recommendation Number 3: The Secretary of HUD should instruct local HUD offices to independently verify appraisals involving investor-owner properties if the investor had recently purchased the property.

Reply: We perform a 10 percent field review of all appraisals concentrating these reviews on problem appraisers and difficult properties. Moreover, cases are targeted for field review by our staff appraisers during the desk review which is done on every case. Through this process, we believe adequate protection is given to the Department's risk. With the recent implementation of the property disposition enhancement to CHUMS (i.e. check all applications to determine whether property formerly owned by HUD), we believe this problem should be further alleviated.

Recommendation Number 4: The Secretary of HUD should instruct local offices to obtain the necessary documentation to support property appraisals such as VA appraisal data.

Reply: We reviewed the claim rate associated with VA appraisals and found no substantive difference in the claim rate from HUD fee panel appraised properties. Moreover, it would be very difficult to justify the need for one government agency to duplicate the work of another. When a problem is uncovered, our field offices are instructed to discuss the issue locally with VA. As a result, we do not believe it is advisable to implement such a policy.

In conclusion, we are extremely proud of FHA's achievements. However, we are also diligent in our desire to remedy any problems which may surface. We believe the steps that have been initiated above clearly demonstrate our commitment to improving our management practices.

Sincerely,

Shirley Wiseman

Shirley McVay Wiseman
General Deputy Assistant Secretary for
Housing-Federal Housing Commissioner

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