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HOMEOWNERSHIP

Management Challenges Facing FHA's Single-Family Housing Operations

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the management problems facing the single-family mortgage insurance programs of the U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Through its FHA, HUD insures private lenders against nearly all losses resulting from foreclosures on single-family homes insured by FHA. FHA-insured single-family home mortgages were valued at about $361 billion as of September 30, 1997. This potential obligation represents a risk to taxpayers because each year, lenders foreclose on a portion of the FHA-insured mortgages that go into default and file insurance claims with HUD for their losses. While FHA's primary single-family mortgage insurance program is self-sufficient, requiring no federal funds to operate, poor program management can contribute to the losses sustained by FHA when foreclosures occur.

My statement will discuss (1) FHA's role in providing mortgage credit to home buyers; (2) management problems affecting the operations of HUD's single-family program, including weaknesses in HUD's oversight of the contractors responsible for safeguarding and maintaining foreclosed FHA properties, indications that weaknesses may exist in HUD's oversight of FHA appraisers, and internal control problems identified in FHA's financial statements audits; and (3) our observations on HUD's plans for addressing these and other single-family management problems as part of its agencywide HUD 2020 Management Reform Plan. My statement today is based on reports recently issued by our office and HUD's Office of Inspector General (OIG); the preliminary results of work being performed at your request on HUD's oversight of FHA appraisers; and the results of our work on HUD's 2020 Management Reform Plan done at the request of the Ranking Minority Members of the Subcommittee on Human Resources and the Subcommittee on Civil Service, respectively, House Committee on Government Reform and Oversight.[1]

In summary:

FHA is a major player in the single-family housing finance market. During the first half of 1997, 3 out of 10 borrowers that received insured mortgages selected FHA mortgage insurance. As we have noted in the past, many families with FHA-insured mortgages are low-income, minority, and first-time home buyers. Without FHA mortgage insurance, some of these

[1]HUD Management: Information on HUD's 2020 Management Reform Plan (GAO/RCED-98-86, Mar. 20, 1998).

borrowers might have had to delay or forgo purchasing a home. Over time, FHA's insurance premiums and other income have more than covered the costs that FHA has sustained as a result of defaults and foreclosures on the single-family loans it insures. In fact, the present value of estimated cash inflows to FHA's single-family mortgage program exceeds the present value of cash outflows by $1.8 billion for fiscal year 1997.

Notwithstanding this strong financial performance, both we and the HUD OIG have identified the following areas in which FHA's management of its single-family program could be improved:

- Our work on HUD's oversight of real estate asset management contractors, who are responsible for safeguarding foreclosed FHA properties, indicates that HUD does not have an adequate system in place to assess its field offices' oversight of these contractors. The three HUD field offices we visited varied greatly in their efforts to monitor real estate asset management contractors' performance, and none of the offices adequately performed all of the functions needed to ensure that the contractors meet their contractual obligations to maintain and protect HUD-owned properties. Our physical inspection of properties for which the contractors in each location were responsible identified problems at the properties, including vandalism, maintenance problems, and safety hazards, which may decrease the marketability of HUD's properties, decrease the value of surrounding homes, increase HUD's holding costs and, in some cases, threaten the health and safety of neighbors and potential buyers.
- Our recent work on appraisals for FHA-insured single-family loans has identified concerns about HUD's oversight of the appraisal process.[2] Since December 1994, private mortgage lenders making FHA-insured loans have been able to select any licensed or certified appraiser listed on FHA's roster. Before that time, appraisals for FHA-insured loans were conducted almost exclusively by a panel of fee appraisers whom FHA assigned to the lenders on a rotational basis. Since implementing the new appraiser selection process, HUD has identified, and begun to address, problems relating to its evaluation of completed appraisals and the number of minorities and women receiving appraisal assignments. Recent limited work we conducted in New Jersey and Ohio showed that some appraisals did not reflect conditions we observed that could adversely affect the structural soundness and continued marketability of the houses and the health and safety of the occupants. In light of these problems, we are

[2]Homeownership: Information on Changes in FHA's New Single-Family Appraisal Process (GAO/RCED-97-176, July 25, 1997).

planning to conduct a broad assessment of HUD's oversight of FHA single-family appraisals.

- In addition, annual audits of FHA's financial statements prepared by KPMG Peat Marwick LLP for HUD's OIG, while noting progress, continue to identify material internal control weaknesses in FHA's operations. The audit report on FHA's fiscal year 1997 financial statements—the most recent available—identified three material internal control weaknesses applicable, in varying degrees, to both the single-family and multifamily programs. The three weaknesses are as follows: (1) FHA must place more emphasis on early warning and loss prevention for insured mortgages, (2) FHA must improve accounting and financial management systems,[3] and (3) FHA must address staff and administrative resource issues. For the single-family programs, the resource issue centers primarily around property management and disposition, staff utilization, and the transfer of resources as FHA consolidates activities and reduces single-family staffing levels.

Under the HUD 2020 Management Reform Plan and related efforts, HUD is in the process of making significant changes in all of its single-family operations, from the initial step of making insurance endorsements to disposing of properties. These changes are motivated in part by HUD's goals of downsizing the agency and addressing long-standing agencywide management weaknesses. While the reforms being implemented appear to address long-standing problems, it is uncertain how effective they will be in eliminating the problems in the single-family programs because the changes are not yet complete and some of the approaches are untested. In addition, because FHA's planned staffing levels are not based upon systematic workload analysis to determine needs, it is uncertain whether HUD's single-family program operations will have the capacity to carry out its responsibilities once the changes are in place.

Before I discuss these issues in greater detail, let me briefly explain how FHA's single-family mortgage insurance program operates.

HUD's Single-Family Mortgage Insurance Program

Unless a buyer can pay cash for a home, he or she must borrow money to finance the difference between the purchase price and down payment. The amount of money borrowed is referred to as a mortgage loan. The home is used as the collateral for the mortgage loan, which is typically repaid in

[3]Also, FHA's single-family systems are not capable of generating the case-specific cash flow data needed to comply with credit reform. As a result, HUD has not been able to accurately report the costs of its credit programs (the primary purpose of credit reform) in its consolidated financial statements—information important to executive and congressional decisionmakers.

monthly installments, generally over a 30-year period. FHA helps Americans finance home purchases. Established under the National Housing Act of 1934, FHA insures private lenders against losses on mortgages financing homes and multifamily and other properties.

Lenders usually require mortgage insurance when a home buyer has a down payment of less than 20 percent of the value of the home because foreclosures are more likely on these loans than on those with higher down payments. Appraisals have an influence on the amount of the mortgage loan. The amount that FHA can insure is based, in part, on the appraised value of the home. The maximum loan amount permitted under FHA's program for single-family homes in the highest-cost areas of the continental United States is currently set at $170,362. In its fiscal year 1999 budget, HUD proposed legislation to increase the maximum mortgage amount insurable under the FHA single-family program in all areas of the country to $227,150.

A mortgage loan is commonly considered "in default" when the borrower misses three consecutive monthly payments and a fourth payment is due. At that point, foreclosure proceedings against the borrower become a serious possibility. In the case of FHA-insured loans, once the foreclosure process is completed, the lender files an insurance claim with HUD for its losses (unpaid mortgage balance and interest, along with the costs of foreclosure and other expenses). After the claim is paid, the lender transfers the title to the home to HUD, which is responsible for managing and selling the property.

The purpose of HUD's property disposition program is to reduce the inventory of acquired properties in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the mortgage insurance fund. To safeguard and maintain the approximately 30,000 properties HUD has in its inventory at any given time, HUD obtains the services of real estate asset management (REAM) contractors. These contractors are to secure and inspect the properties, report their condition to HUD, notify interested parties of HUD's ownership, perform exterior maintenance, and ensure that the properties are free of debris and hazardous conditions. REAM contractors are therefore essential to HUD's achieving its goal of returning these properties to private ownership as soon as possible, while obtaining a maximum sale price for HUD.

FHA's Role in the Single-Family Mortgage Market

FHA insured over 740,000 home mortgages representing over $61 billion in single-family mortgage insurance during fiscal year 1997—ending the fiscal year with a total of $361 billion in single-family mortgage insurance outstanding. During the first half of 1997, FHA insured about 8 percent of all mortgages made or about 31 percent of all mortgages that were insured.

Many changes have occurred in the single-family housing finance system since the FHA was established. These changes include the advent of modern private mortgage insurance, the development of a secondary mortgage market, and the emergence of a number of public-and private-sector initiatives designed to expand affordable housing opportunities for home buyers. Given these developments, an ongoing debate has centered on whether there is still a need for FHA's single-family mortgage insurance program and, if so, what changes, if any, need to be made to the program. Critics of FHA contend that other housing finance players, such as the private mortgage insurers, are filling the need once filled exclusively by FHA. Supporters of FHA argue that its single-family program, which has insured at least 24 million home mortgages since its inception, remains the only way for some families to become homeowners and should be expanded.

FHA has been a major player in single-family home financing for over 60 years, and it remains so today—particularly in certain market segments. As mentioned above, FHA insured about 31 percent of all insured mortgages during the first half of 1997. According to FHA, 76 percent of new mortgages it insured last year were for first-time home buyers, and FHA provided the primary homeownership opportunity for central cities' residents. In our report on FHA's role, we found that in 1994, FHA-insured loans were concentrated to a greater extent on low-income and minority borrowers, first-time home buyers, and borrowers with higher loan-to-value (LTV) ratios than those with loans insured by private mortgage-insurers.[4] FHA was also the primary insurer in nine states. In addition, solely on the basis of the LTV and qualifying ratios of borrowers who obtained loans in 1995, 66 percent of FHA's borrowers might not have qualified for private mortgage insurance for the loans they received. Recent Home Mortgage Disclosure Act (HMDA) data show that in comparison with its share of the mortgage market, FHA in 1996 generally served a greater share of the market segments consisting of minority borrowers, low- and moderate-income borrowers, and borrowers located

[4]Homeownership: FHA's Role in Helping People Obtain Home Mortgages (GAO/RCED-96-123, Aug. 13, 1996).

in low- and moderate-income neighborhoods and neighborhoods where minorities represent more than 30 percent of all residents.

Furthermore, according to Price Waterhouse's 1998 actuarial study, the Mutual Mortgage Insurance Fund (the Fund)—the insurance fund supporting FHA's principal single-family insurance program —had an economic value/reserves of about $11.3 billion as of September 30, 1997. Over time, insurance premiums and other income have more than covered costs. In fact, the present value of estimated cash inflows to FHA's single-family mortgage program exceeds the present value of cash outflows by $1.8 billion for fiscal year 1997.[5]

FHA's Fund has surpassed the legislative target for reserves (a 2-percent capital ratio by November 2000). As we have reported, the Fund's ability to maintain the target ratio will depend on many economic, program-related, and other factors that will affect the financial health of the Fund in the future. The economic factors include interest rates, unemployment, and, in particular, house price appreciation rates. Program-related factors include the introduction of loss mitigation procedures that may reduce future losses from claims; changes in underwriting standards, such as the elimination of "teaser" interest rates for adjustable rate mortgage (ARM) loans; and the elimination of the Mortgage Assignment Program. Other factors that may affect the financial health of the Fund in the future include the uncertainty surrounding the projections of the performance of FHA's streamlined refinanced and ARM loans, because FHA has had less experience with these types of loans than with their more traditional 30-year, fixed-rate mortgage.

The greater the extent that FHA can improve the efficiency of its lending operations, the greater its ability to maintain financial self-sufficiency in an uncertain future and meet the needs of lower-income borrowers through either increasing the number of borrowers served or reducing the cost of insurance for those FHA serves. In spite of the overall success of FHA's single-family mortgage insurance program, both we and the HUD OIG have identified weaknesses in program management. I would now like to discuss these problems.

[5]For FHA's mutual mortgage insurance and cooperative management housing insurance programs.

Weaknesses Exist in HUD's Oversight of REAM Contracts

Our report on HUD's property management and contract administration, which you are releasing today, revealed problems with HUD's oversight of REAM contractors.[6] Our audit work found that HUD does not have a system in place for monitoring its field offices' administration of REAM contracts. HUD's guidance gives headquarters staff the ultimate responsibility for overseeing the administration of REAM contracts. Specifically, the guidance requires regional offices to ensure that field offices are monitoring REAM contractors, and requires headquarters staff to review regional offices' oversight actions through regional reviews. We found, however, that headquarters staff have not been conducting these reviews since HUD reorganized its field office structure in 1995 and eliminated the regional offices.

In addition, HUD's field office staff are not consistently providing adequate oversight of REAM contractors. We believe this lack of oversight contributed to some of the poor property conditions, ranging from graffiti and debris to imminent safety hazards, that we saw when we visited 66 HUD properties. Such conditions can decrease the marketability of HUD's properties, decrease the value of surrounding homes, increase HUD's holding costs and, in some cases, threaten the health and safety of neighbors and potential buyers. Our report makes recommendations to HUD for improving its oversight of REAM contractors.

Some Key Oversight Responsibilities Not Always Performed

HUD's field office staff are directly responsible for overseeing REAM contractors. We found, however, that some key oversight responsibilities were not always performed by staff at the three HUD field offices we visited. For example, HUD's field staff did not always conduct evaluations of REAM contractors as required. Field office staff are supposed to evaluate the REAM contractor's performance every year in the month prior to the contract's anniversary date. This annual evaluation is used to make decisions on contract extensions and, if necessary, to act on inadequate performance. However, we found in all three field offices we visited that these evaluations were not always conducted or were not always completed in time to provide useful information for contract renewal decisions. For example, one of the field offices we visited has evaluated the REAM contractor's performance only once since the REAM contract was awarded in June 1995, and that evaluation was conducted several weeks after the contract had already been extended beyond the base year. Officials in that field office told us that performance evaluations were not

[6] Single-Family Housing: Improvements Needed in HUD's Oversight of Property Management Contractors (GAO/RCED-98-65, Mar. 27, 1998).

performed because they did not have the staff resources or travel funds to visit the contractor's office. However, it should be noted that the REAM contractor's office is only 37 miles from HUD's field office.

Furthermore, in the one evaluation conducted, field office staff did not convey the results of the evaluation to the REAM contractor, as required. In this evaluation, HUD cited the contractor for failing to remove debris from some properties. Our inspection of properties in this field location revealed that the debris removal problem still exists. One property had been shown by realtors eight times while it contained debris. In fact, a realtor noted that the only accessible entrance to the property was blocked with furniture and debris, which was also the case when we visited the property. During our August 1997 inspection of 24 properties in this location, we found that most of the properties contained either interior or exterior debris. Consequently, prospective buyers were sometimes viewing properties littered with household trash, personal belongings, and other debris.

In addition, HUD's field office staff did not always inspect properties managed by REAM contractors, as suggested by HUD's guidance. Because HUD recognizes that physical inspections are the best method for monitoring the contractors' work, HUD's guidance suggests that field office staff conduct monthly physical inspections of a minimum number of properties assigned to each contractor. To help meet this target, the guidance allows the field offices to contract out for property inspection services. Without adequate on-site inspections, HUD cannot be assured that it is receiving the services for which it has paid. In two of the field offices we visited, property files contained evidence that some properties were being inspected. However, in the third field office, we found that of the 42 property files we reviewed, HUD's field office staff had not inspected any of those properties. Field office staff told us they did not get out to inspect properties because they did not have the travel funds or staff resources to do so. Subsequent to our visit, in December 1997, this field office started using contractors to make property inspections.

Moreover, HUD's field office staff did not always ensure that the REAM contractors conducted property inspections and submitted appropriate reports for HUD's review. HUD's guidance requires REAM contractors to submit initial inspection reports within 5 working days of being notified that a property has been assigned, but it offers no specific guidance on the submission of routine inspection reports. The REAM contractor's submission of initial and routine inspection reports is essential for HUD to determine its marketing strategy for the properties and to mitigate potential losses to the properties. For example, the initial inspection reports, along with appraisals, are the primary tools for determining the repairs that must be made and whether the property meets certain standards that would allow it to be sold with FHA-insured financing. We found, however, considerable differences among the three field offices we reviewed both in terms of the requirements they placed on REAM contractors for submitting inspection reports and the extent to which the reports were actually submitted to the field offices. For example, in one location all of the property files we reviewed contained initial inspections, while in another location, 43 percent of the files contained no initial inspections. Without inspection reports, HUD is unable to readily determine whether the contractors are conducting inspections as required.

REAM's Inadequate Performance and Weaknesses in HUD's Oversight Contribute to Poor Property Conditions

In all three locations that we visited, we found instances of properties that were not maintained as required by the REAM contracts. During our inspection of approximately 20 properties in each location, we identified properties that (1) were not properly secured; (2) had physical conditions that did not match those that the REAM contractor had reported to HUD; or (3) had imminent hazards.

For instance, of the 66 properties we visited in all three locations, we found that approximately 39 percent were not sufficiently secured so as to prevent access to the property. Failure to properly secure properties can lead to trespassing, vandalism, and property deterioration. In fact, we visited unsecured properties that had broken windows, graffiti, and exposed walls in the bathrooms where valuable copper piping had been ripped out.

In addition, we found physical conditions that did not match those that the REAM contractors had reported to the three HUD field offices we visited. For example, one property contained animal feces, fur, and personal possessions, while the contractor's inspection report indicated that the house was free of debris. If contractors do not accurately report on the condition of properties, HUD may lack vital information on which to make disposition decisions and to address safety hazards. As a result, the government may sell the property for less than it is worth or incur unnecessary holding and maintenance costs because it is not marketable.

Furthermore, almost 71 percent of the properties we visited in one field office and about 37 percent in another, contained imminent hazards, such as broken or rotting stairs. Inspection reports submitted to HUD for one property noted that the front steps were dangerous, a condition warranting immediate repair by the contractor. Nonetheless, when we inspected the property about 3 months after the contractor initially reported the problem, the stairs still had not been repaired. Other imminent hazards we saw included a refrigerator on a back porch with the door intact and properties containing household waste, food, soiled diapers, and paints and solvents. Failure to address imminent hazards endangers would-be buyers as well as neighbors and puts the government at risk of litigation.

On the basis of our review of files and properties in three locations, we found that the properties were generally in better condition in the locations where staff more actively monitored the contractors' performance. We recognize, however, that the condition of the properties is not totally attributable to HUD's oversight of the contractors. Other factors can contribute to the condition of the properties, including the overall quality of the contractor's work and the susceptibility of the neighborhood to crime and vandalism.

Concerns About HUD's Oversight of Single-Family Appraisals

Our recent work on appraisals for FHA-insured single-family loans has also identified concerns about HUD's oversight capabilities. Appraisals are an important aspect of the underwriting process for FHA-insured mortgages because they influence the amount of the loan and FHA's corresponding financial exposure. Since December 1994, private mortgage lenders making FHA-insured single-family loans have been able to select any licensed or certified appraiser listed on FHA's roster. Before that time, appraisals for FHA-insured loans were conducted almost exclusively by a panel of fee appraisers whom FHA assigned to the lenders on a rotational basis. In our July 1997 report cited earlier, we reported on the new appraiser selection process, including problems relating to HUD's evaluation of completed appraisals and the number of appraisals assigned to minorities and women. Recent limited work we conducted in New Jersey and Ohio in response to concerns voiced by some former fee panel appraisers raises additional questions about HUD's oversight of the appraisal process.

HUD's Efforts to Address Implementation Problems

The Congress enacted the change to lenders' selection of appraisers to improve both the efficiency of FHA lenders and the quality and reliability of appraisal services. Our July 1997 report noted that HUD had identified two problems since implementing the new system. First, some HUD field offices were conducting few or no field reviews of completed appraisals. HUD uses the results of these reviews to assess the performance of appraisers and identify those appraisals that do not accurately assess the condition and value of appraised properties. We recommended that HUD require its field offices to select a specific percentage of appraisals for review and establish a process for ensuring that field offices meet this requirement. In response to this recommendation, HUD established a policy which requires the field offices to review no less than 10 percent of all the appraisals conducted within their jurisdiction. An official from HUD's Office of Insured Single-Family Housing told us that to ensure compliance with this policy, HUD had made the 10-percent requirement part of the criteria used to rate the performance of field office staff.

The second problem noted in our report was that minority and women appraisers were not obtaining appraisal assignments under the new selection process in the same proportion as they did when FHA assigned the appraisers. To help address this situation, HUD announced in November 1997 that it would post lenders' appraiser selections on its Internet site. For lenders that complete five or more appraisals per month, HUD intends to list the number and percentage of appraisals performed by white males and females, and minority males and females, along with the number and percentage of each group represented on the field office's appraiser roster. HUD plans to begin posting these data around the end of April 1998.

Recent Work in New Jersey and Ohio

Some former fee panel appraisers are opposed to the change in FHA's appraiser selection process because they believe that some lenders are selecting appraisers who are not accurately reporting the value and physical condition of the homes they appraise. They believe that if left uncorrected, this situation will increase financial risks to FHA if borrowers default on their mortgage loans. They also contend that inaccurate reporting on the physical condition of homes results in borrowers not knowing the extent and cost of needed home repairs.

In response to the concerns raised by these individuals, we recently visited six homes in New Jersey and three homes in Ohio to determine the extent to which the appraisals for these properties completely and accurately described their condition. The properties were selected by the fee panel appraisers in order to illustrate their concerns and therefore were not representative of all properties appraised for FHA mortgage insurance. Nevertheless, the problems we found during the course of our work raise questions about the quality of some appraisals and HUD's oversight of the appraisal process.

The purpose of an FHA appraisal is to (1) determine the property's eligibility for mortgage insurance on the basis of its condition and location and (2) estimate the value of the property for mortgage insurance purposes. In performing these tasks, the appraiser is supposed to identify any deficiencies impairing the safety, sanitation, structural soundness, and continued marketability of the property and assess the property's compliance with FHA's other minimum property standards. According to HUD's guidance, if an appraiser finds noncompliance with these standards, the appraiser should include in the appraisal report an appropriate and specific action to correct the deficiency. It further states that the appraiser should reject a property for purposes of FHA mortgage insurance when compliance with FHA's minimum standards is not feasible or would require major repairs or alterations. To be listed on HUD's roster, appraisers are required to sign a document stipulating that they have read pertinent HUD guidance.

The appraisals for eight of the nine properties we visited in New Jersey and Ohio did not reflect conditions we observed that could adversely affect the structural soundness and continued marketability of the houses and the health and safety of the occupants.[7] As of February 1998, five of these eight properties had been purchased with an FHA-insured mortgage. For the remaining three properties, the mortgage lender had either not approved the mortgage or had not submitted the case to HUD for approval of mortgage insurance. Examples of conditions we observed that were not reflected in the appraisals included termite damage, masonry and foundation damage, makeshift structural supports, rotted siding, and deteriorated roofing shingles. In one instance, the appraisal report did not mention, or call for repair or inspection of, an approximately 30-inch wide, 4-inch deep notch that had been cut into a load-bearing beam. In another instance, the appraisal made no mention of an uncovered, pull-cord light fixture located above a bathtub and shower.

Our work at HUD's Camden, New Jersey, and Cleveland, Ohio field offices revealed apparent weaknesses in their oversight of appraisers. For example, a HUD contractor who performed field reviews on the appraisals for three of the six New Jersey homes concluded that the appraisers overlooked serious deficiencies and should have rejected the properties.

[7]The remaining property did not have any significant deficiencies, and the appraisal accurately reflected the condition of the home.

Although field reviews are an important tool for identifying poor-performing appraisers, HUD's Camden office could locate only one of the three field review reports in its files. Moreover, HUD's Philadelphia Homeownership Center (HOC) subsequently approved FHA mortgage insurance for one of these three properties, even though the center's staff had information about the problems with the appraisal and the condition of the home. After we brought this situation to the attention of the homeownership center's director, he acknowledged that the property should not have been insured and removed the appraiser from FHA's roster. The homeownership center also instructed the mortgage lender to pay for the repairs that were necessary to bring the property into compliance with FHA's standards.

At HUD's Cleveland office, we found that the appraiser for two of the three Ohio properties had received four "unacceptable" ratings on field reviews conducted in fiscal year 1997, grounds for possible removal from FHA's roster of appraisers. However, a single-family housing specialist from HUD's Cleveland office told us that because of staffing constraints, none of the four field review reports had been reviewed by HUD's technical staff and that no disciplinary action had been taken against the appraiser. The official also stated that field reviews were generally not a reliable monitoring tool because of the poor performance of some field review contractors and their high turnover rate. It is important to note that as HUD consolidates its single-family housing activities into four homeownership centers and reduces its single-family housing staff, HUD may need to rely even more heavily on field review contractors and lenders to oversee the appraisal process.

Mr. Chairman, because of the problems we found during the course of this work, we are planning to conduct, as you requested, a broad assessment of HUD's monitoring and oversight of FHA single-family appraisals.

Financial Statement Audits Have Identified Internal Control Weaknesses

Annual audits of FHA's financial statements, while noting progress, also continue to identify weaknesses in FHA's operations.[8] The audit report on FHA's fiscal year 1997 financial statements—the most recent available—identified three material internal control weaknesses applicable, in varying degrees, to both the single-family and multifamily programs.[9]

- FHA must place more emphasis on early warning and loss prevention for insured mortgages. According to the report, FHA does not have adequate systems, processes, or resources to effectively identify and manage risks in its insured portfolios. Timely identification of troubled insured mortgages is a key element of FHA's efforts to target resources on insured high-risk mortgages. Troubled insured mortgages must be identified before FHA can institute loss mitigation techniques that can reduce eventual claims. The report notes that although the single-family insured mortgage portfolio is large, automated monitoring using statistical and trend analysis can be used effectively.
- FHA must improve accounting and financial management systems. According to the report, some of FHA's automated systems either do not provide needed management information or do not produce reliable information. The report also stated that better information systems for strategic decision-making would make monitoring more productive and staff more efficient. Also, FHA's single-family systems are not capable of generating the case-specific cash flow data needed to comply with federal credit reform.[10] As a result, HUD has not been able to accurately report the costs of its credit programs in its consolidated financial statements. This information is important to executive branch and congressional decisionmakers for budget decisions.
- FHA must address staff and administrative resource issues. According to the report, FHA's staffing needs continue to be critical in the multifamily insured portfolio monitoring area. In the past, FHA's staffing issues have

[8]The Chief Financial Officers Act of 1990 required HUD and some other agencies to report annually to the Congress on their financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet part of this requirement, HUD's Office of Inspector General contracts with a public accounting firm to conduct annual audits of FHA's financial statements.

[9]Federal Housing Administration Audit of Fiscal Year 1997 Financial Statements, prepared by KPMG Peat Marwick LLP for the Office of Inspector General (98-FO-131-0003, Mar. 9, 1998).

[10]Problems with financial data and systems have impaired HUD's ability to comply with both the Credit Reform Act of 1990 and the requirements of Statement of Federal Financial Accounting Standards Number 2, Accounting for Direct Loans and Loan Guarantees (Credit Reform), which generally mirrors the act. Credit reform relates primarily to how HUD budgets and accounts for losses and costs associated with its direct loan and loan guarantee programs. A primary purpose of credit reform is to more accurately measure the costs of federal credit programs.

included staffing shortages (in the case of single-family, the shortages primarily existed in the note servicing area), barriers to effective redeployment of staff, mismatches between skill sets and skill needs, and inadequate training resources. According to the report, for the single-family program, the issue now centers primarily around property management and disposition, staff utilization, and transfer of resources as FHA consolidates activities and reduces 1995 single-family staffing levels by almost 60 percent by 2002. The reduction of staffing levels in single-family housing programs, according to HUD, stems primarily from the elimination of most loan servicing and property disposition activities.

Planned and Ongoing Efforts to Reform Single-Family Housing Operations

Under its HUD 2020 Management Reform Plan and related efforts, HUD is in the process of making significant changes in single-family housing operations, from the initial step of making insurance endorsements to disposing of properties. These changes are motivated in part by HUD's goals of downsizing the agency and addressing long-standing management weaknesses.

HUD's 2020 Management Reform Plan Proposes Significant Changes

In June 1997, HUD announced its HUD 2020 Management Reform Plan, a sweeping set of proposals intended to, among other things, address identified management weaknesses and continue downsizing the Department from about 10,500 (fiscal year 1996 levels) to 7,500 by 2000 (subsequently extended to 2002). The plan outlined a number of organizational changes, including the consolidation of similar functions within and across the agency's main program areas, as well as staff reductions and target staff levels for each of the areas. For single-family housing, the 2020 plan identifies and seeks to address flaws in the current structure and operations, including delays and problems in processing insurance endorsements, information systems that do not help staff effectively monitor compliance, and poorly controlled and monitored disposition of properties. Under the plan, HUD is consolidating all single-family housing operations from 81 locations across the nation into four single-family HOCs; privatizing or contracting out most property disposition activities; and eliminating most loan servicing functions by selling the inventory of HUD-held mortgages.

Once fully operational, the consolidation of functions in the HOCs and planned technology improvements are expected to address the problems facing single-family housing programs. For example, each HOC will have a Processing and Underwriting Division that provides insurance endorsements, operational post-endorsements, fee panel oversight, and underwriting guidelines.[11] This change is expected to address the delays and other problems with processing insurance endorsements.

Also, each HOC will have a Quality Assurance Division to perform quality control post-endorsement technical reviews, monitor lenders, impose sanctions, and perform audits/investigations. Overall, the quality assurance staff will be increased by 33—from February 1998 staffing of 43—by the end of fiscal year 1998. Also, the Denver HOC will have a Servicing and Loss Mitigation Division for servicing advice and guidance to mortgagees, loss mitigation, and loan servicing. These changes may help address the material internal control weakness concerning early warning and loss prevention for insured mortgages. In any event, for these initiatives to be successful, FHA must implement effective information systems to support them.[12]

Furthermore, each HOC will have a Real Estate Owned Division to handle property disposition. Although all property disposition activities are planned to be transferred to the HOCs by September 1998, HUD is considering alternative methods for disposing of its single-family housing inventory. Specifically, according to HUD Single-Family Housing Division officials, the Department plans to sell the rights to properties before they enter inventory, thus enabling them to be quickly disposed of once they become available. Although the details of these sales, which HUD refers to as "privatization sales," remain to be developed, HUD envisions that properties would be pooled on a regional basis and purchased by entities that could use their existing structures to sell the properties in the same way that the Department currently does, through competitive sales to individuals. In addition, as a part of its budget request for fiscal year 1999, HUD is proposing new legislation to allow the Department to take back notes when a claim is paid, rather than requiring lenders to foreclose and convey properties. HUD would then transfer the note to a third party for servicing and/or disposition.[13] According to the single-family housing officials, as a result of these proposed changes, HUD anticipates having

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[11]Each HOC will also have a Marketing and Outreach Division for promoting homeownership through home buyer education and implementation of partnership agreements with state/local governments, nonprofits, community organizations, and local industry/trade groups.

[12]Information Technology: Streamlining FHA's Single Family Housing Operations (GAO/AIMD-97-4, Oct. 17, 1996).

[13]Although the legislation is proposed for enactment in 1999, the program would not take effect until 2002, to allow HUD time to issue regulations and mortgage lenders time to adjust to the new procedures.

only a minimal inventory of properties in the future and, therefore, only a limited need for REAM contractors' services.

The 2020 plan also calls for HUD to modernize and integrate outdated financial management information systems with an efficient state-of-the-art system, incorporating such features as efficient data entry, support for budget formulation and execution, updates on the status of funds, standardized data for quality control, and security control. The plan also states that information and accounting systems that do not comply with the Federal Managers' Financial Integrity Act—which includes single-family housing systems—would be overhauled to correct deficiencies, consolidate functions into the new accounting systems, or be eliminated. Recently, the Department decided to forgo purchasing a new software package to integrate its financial systems. Instead, it will continue to implement the Federal Financial Systems software, which it began using in 1995. Current plans call for fully implementing this system as HUD's core financial system and integrating it with the program feeder systems by September 1999. As you know, at your request we are currently reviewing HUD's effort to integrate its systems.

Prior to the 2020 plan, FHA developed an overall integration strategy along program lines (single-family, multifamily and Title I housing). The strategy is designed to eliminate outdated systems and save the systems that provide current, reliable data. In our February 1997 High-Risk series report on HUD, we reported that the estimated completion date for FHA's systems' integration project was 2001.[14] In the March 1998 report on FHA's fiscal year 1997 financial statements, the auditors stated that although progress had been made in systems' integration, including bringing new systems on line, much work remained to be done. The auditors also noted that FHA's inability to quickly develop or acquire more modern information technology will continue to deter its efforts to be a more efficient and effective housing credit provider.

Effectiveness of Planned Changes Is Uncertain

At the request of the Ranking Minority Members of the Subcommittee on Human Resources and the Subcommittee on Civil Service, respectively, House Committee on Government Reform and Oversight, we reviewed HUD's support underlying specific features of the 2020 plan. In our March 1998 report,[15] we reported that the proposed changes in

[14]High-Risk Series: Department of Housing and Urban Development (GAO/HR-97-12, Feb. 1997).

[15]HUD Management: Information on HUD's 2020 Management Reform Plan (GAO/RCED-98-86, Mar. 20, 1998).

single-family housing operations are based on some empirical analysis as well as other factors. According to the Deputy Assistant Secretary for Single-Family Housing, an in-house team of senior managers developed the homeownership center concept on the basis of the regional office structure of the Federal National Mortgage Association (Fannie Mae).[16] Fannie Mae serves the entire United States through offices in Atlanta, Georgia; Chicago, Illinois; Dallas, Texas; Pasadena, California; and Philadelphia, Pennsylvania. Certain functions performed by FHA generally parallel some of those performed by other organizations in the single-family mortgage industry, such as Fannie Mae. In 1994, as a pilot project, FHA began consolidating its loan processing operations for single-family housing that were performed in 17 of its field offices into the Denver HOC. According to HUD, the pilot showed that consolidating work at one site and increasing the use of technology could reduce insurance endorsement processing time from 2 weeks to as little as 1 day.

The 2020 Management Reform Plan includes steps to downsize the agency. In our work for the House Government Reform and Oversight subcommittees, we found that proposed staffing levels for each of HUD's program areas, including Housing, are generally not based on systematic workload analyses to determine needs. While the HUD teams that helped develop the 2020 plan were instructed by the Deputy Secretary to determine staffing requirements on the basis of workload, they were also instructed to work within targeted staffing levels and the Department's staffing constraints. FHA's proposal to carry out single-family housing activities with the reduced staffing level stems primarily from the elimination of most loan servicing and property disposition activities. According to the Deputy Assistant Secretary for Single-Family Housing, the proposed staffing level is based on past experience, input from the planning team, and staffing levels at the Denver HOC. A report by the team reviewing Housing operations indicates that the loan processing functions in the Denver HOC were carried out with half the number of the staff who were responsible for those functions in the 17 field offices.

There is uncertainty about the degree to which HUD will continue to rely on contractors for property disposition activities. According to Single-Family Housing officials, until new approaches are fully implemented, HUD staff will be responsible for disposing of the current inventory and any new properties coming into the inventory by using property management and marketing contracts similar to those issued under a recent pilot program,

[16]Fannie Mae is a government-sponsored enterprise that helps ensure that funds are available to home buyers by buying mortgages from mortgage originators, such as savings and loans, commercial banks, and mortgage bankers.

which tests the approach of contracting out all property management and marketing services.[17] Furthermore, even after the privatization sale approach is implemented, there will likely continue to be a relatively small number of properties that HUD does not dispose of through these sales. Such properties would be managed and disposed of using contracts similar to those used in the pilot. Accordingly, it appears that HUD's property disposition operations will continue to rely on contractors' services to some extent for the foreseeable future. Furthermore, if the alternative approaches do not operate as well as hoped, according to Single-Family Property Disposition officials, HUD will rely heavily on contracts similar to those issued under the pilot. However, as discussed in the previous section, HUD headquarters has no mechanisms for regularly monitoring field offices' oversight of contractors' activities. As of December 1997, none of the ongoing or planned changes to the property disposition process established a system to ensure adequate monitoring by headquarters of field offices' oversight.

In closing, Mr. Chairman, FHA is a prominent player in the home mortgage loan market, particularly for low-income and minority borrowers, first-time home buyers, and borrowers with high LTV ratios. Also, FHA has been able to serve such borrowers without the need for any federal funds. While the Fund supporting nearly all of FHA's single-family mortgages is financially healthy and is projected to continue to improve at least in the near term, improving FHA's management over its single-family mortgage insurance operation would enhance the Fund's ability to maintain financial self-sufficiency in an uncertain future. This is important because forecasts to determine whether FHA will have the funds it needs to cover its losses over the 30-year life of an FHA mortgage are uncertain. Loan performance will depend on a number of economic and other factors over that period, such as changes that affect losses from claims.

While HUD has formulated approaches and initiated actions to address its single-family housing management problems, efforts are far from reaching fruition and uncertainties exist. Correcting these problems would help reduce the risks associated with FHA's single-family mortgage insurance operations as well as reduce its vulnerability to waste, fraud, abuse, and mismanagement. In addition, FHA is making or proposing major changes in its single-family insurance operations that will affect its organization,

[17] According to Single-Family Property Disposition officials, field offices with fewer than 10 remaining staff responsible for management and sales of properties in inventory will use contracts similar to those issued under the pilot, but field offices with 10 or more such staff will continue to use REAM-type contracts.

processes, and the maximum mortgage amount insurable while reducing its staff. Because the changes are not yet complete and full operations of the HOCs are untested, the extent to which they will address the problems of single-family housing management is uncertain. In addition, because the downsizing target for FHA's single-family mortgage insurance operations is not based on systematic workload analysis to determine need, it is uncertain whether single-family housing will have the capacity to carry out its responsibilities once the changes are in place. FHA's challenge is to implement such changes in an era of diminishing resources, while managing existing commitments and improving its management of the single-family mortgage insurance program.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Subcommittee may have. As indicated earlier in our statement, we are continuing to review issues related to HUD's single-family mortgage insurance operations and look forward to sharing the results of our work with the Subcommittee.

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