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HOME IMPROVEMENT

Weaknesses in HUD's Management and Oversight of the Title I Program

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The Honorable Rick A. Lazio
Chairman, Subcommittee on Housing
and Community Opportunity
Committee on Banking
and Financial Services
House of Representatives

The Honorable Kenneth E. Bentsen, Jr.
House of Representatives

Homeowners who have little equity in their homes at times obtain property improvement loans under Title I of the National Housing Act to make alterations or repairs. These loans are made by banks and other private lenders from their own funds and are insured by the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). If borrowers default on their loans, banks submit claims to HUD, which pays or denies them.

Concerned about how well this Title I program was being operated, you asked us to determine (1) the extent to which the information needed to manage the program was available to HUD; (2) the extent to which HUD was overseeing the program's lenders; (3) whether options and information presented by Price Waterhouse in its HUD-commissioned study of the Title I program could provide lenders with greater incentives to improve loan underwriting[1] and servicing; and (4) whether HUD has any efforts planned or under way to strengthen its management and oversight. In April 1998, we testified on the preliminary results of our work before the Subcommittee on Housing and Community Opportunity of the House Committee on Banking and Financial Services.[2]

Results in Brief

HUD is not collecting the information needed for managing the Title I property improvement loan program. Specifically, we found that when loans are made, HUD collects little information on the borrowers, the properties, or the loan terms, such as the borrowers' income and the addresses of the properties being improved. Moreover, HUD does not

[1]Underwriting is the process of analyzing a borrower's willingness and ability to repay a loan.

[2]Home Improvement: Weaknesses in HUD's Management and Oversight of the Title I Program (GAO/T-RCED-98-177, Apr. 30, 1998).

maintain information on why it denies loan claims or why it subsequently approves some of those claims for payment.

HUD provides limited oversight of lenders' compliance with the program's regulations. It conducted four on-site quality assurance reviews of lenders in fiscal year 1997 of the approximately 3,700 lenders participating in the program.[3] Regarding the need for oversight of lenders' compliance, we found that loan claim files submitted by lenders to HUD following loan defaults often do not contain required loan documents, including the original loan applications and certifications signed by the borrowers stating that the property improvement work has been completed. In addition, some claims are paid by HUD even though there are indications that the lenders did not comply with the required underwriting standards when insuring the loans.

In August 1997, Price Waterhouse in its HUD-commissioned review of the Title I program reported, among other things, on options and provided information on how to restructure the program, such as further restricting the use of Title I loan proceeds and capping loan interest rates. These options could provide greater incentives for lenders to improve the making and servicing of the program's loans.

Under HUD's 2020 Management Reform Plan and related efforts, the agency is making significant changes in all of its single-family housing programs, including the Title I program. These changes are motivated in part by HUD's goals to downsize the agency and to address long-standing agencywide management weaknesses. The changes being made that affect the Title I home improvement insurance program include (1) streamlining and automating the program's claims examination process and (2) consolidating the agency's efforts to monitor lenders into four locations. However, it is uncertain whether these changes will affect the weaknesses we identified in the oversight of the Title I program.

Background

The Title I property improvement program was established by the National Housing Act (12 U.S.C. 1703) to encourage lending institutions to finance property improvement projects that would preserve the nation's existing housing stock. Under the program, FHA insures 90 percent of a lender's claimable loss on an individual defaulted loan. The total amount of claims

[3]In our April 1998 testimony on the preliminary results of our Title I work, we reported, based on information provided by HUD, that HUD had conducted two reviews of Title I lenders in fiscal year 1997. Subsequently, additional information provided by HUD showed that it had conducted two other reviews of Title I lenders in fiscal year 1997.

that can be paid each year to a lender is limited to 10 percent of the value of the total program loans held by each lender. In fiscal year 1997, FHA paid about $112 million on 8,179 Title I property improvement claims. Since the inception of the program in 1934, FHA has provided credit protection for Title I loans for over 35 million households to finance a variety of alterations and repairs. These property improvements are intended to improve or protect the basic livability or utility of a home, including structural additions and alterations; siding; roofing; insulation; and plumbing, heating, and cooling systems. Although property improvement loans made under Title I can be obtained for other types of structures, most loans are for improvements to single-family homes.[4]

Today, the value of the outstanding loans in the Title I program is relatively small compared with FHA's other housing insurance programs. As of September 30, 1997, the value of loans outstanding on the property improvement program totaled about $4.4 billion on 364,423 loans. By contrast, the value of outstanding FHA single-family home loans in its Mutual Mortgage Insurance Fund totaled about $360 billion. Similarly, Title I's share of the remodeling market for owner-occupied, single-family homes is small—estimated at about 1 percent by the National Association of Home Builders and estimated by HUD at about 3.1 to 3.6 percent of the total financed home improvement work.

Approximately 3,700 lenders are approved by FHA to make Title I loans. Lenders are responsible for managing many aspects of the program, including establishing interest rates and loan terms, making and servicing loans, monitoring the contractors, and dealing with borrowers' complaints. In conducting these activities, lenders are responsible for complying with FHA's underwriting standards and regulations and for ensuring that home improvement work is inspected and completed. FHA is responsible for approving lenders, monitoring their operations, and reviewing the claims submitted for defaulted loans. The Title I program's officials consider lenders to have the sole responsibility for the program's operations and HUD's role to be primarily overseeing lenders and ensuring that the claims paid on defaulted loans are proper.

A homeowner obtains a property improvement loan by applying directly to a Title I lender or by having a Title I lender-approved dealer—that is, a contractor—prepare a credit application or otherwise assist the

[4]Title I property improvement loans also may be used for multifamily housing and nonresidential structures. Under another component of the program, loans insured by FHA can be used to purchase manufactured homes. A manufactured home is built entirely in a factory, transported to a homesite, and installed.

homeowner in obtaining the loan from the lender. For a direct loan, the proceeds are disbursed to the homeowner when the Title I loan is approved. However, the proceeds from a loan obtained through the assistance of a dealer are disbursed by the lender to the dealer when the home improvement work is completed. During fiscal years 1986 through 1996, about 520,000 direct and 383,000 dealer loans were made under the program. In calendar year 1997, about 60 percent of the loans (49,872) were made directly to borrowers, while 40 percent (33,360) were made through dealers. By statute, the maximum amount of property improvement loans is $25,000 on a single-family home, and the maximum loan term is about 20 years. Loans in excess of $7,500 must be secured by a recorded lien on the property being improved.

Title I regulations require borrowers to have enough income to meet the periodic payments required by a property improvement loan. HUD's guidelines generally require that borrowers' total fixed expenses not exceed 45 percent of the their effective gross income. However, this expense-to-income ratio can be exceeded if a lender determines and documents compensating factors concerning a borrower's credit worthiness that would support approval of the loan. Most Title I borrowers have low to moderate incomes, little equity in their homes, and/or poor credit histories. According to data collected by Price Waterhouse in an August 1997 study of the Title I program, most Title I borrowers nationally in 1995 had incomes that were at or near median area incomes. The exception was borrowers in California, where about 70 percent of the borrowers had incomes that were 115 percent above the area median income. Nationwide, the average size of a loan was $12,163 as of September 1997.

HUD's expenses under the Title I program, such as the claim payments made by FHA on defaulted loans, are financed from three sources of revenue: (1) insurance charges to lenders of 0.5 percent of the original loan amount for each year the loan is outstanding, (2) funds recovered from borrowers who defaulted on loans, and (3) appropriations. In the August 1997 report, Price Waterhouse concluded that the program was underfunded during fiscal years 1990 through 1996. Price Waterhouse estimated that a net funding deficit of about $150 million occurred during the period, with a net funding deficit in 1996 of $11 million.[5] Data from the

[5]Price Waterhouse defined the net funding position as the current value of the premiums collected minus the current value of the claims. Current value refers to past payments plus accumulated interest, plus expected future payments discounted by the interest rate on 5-year U.S. Treasury bonds. The estimated negative net funding deficit implies that premiums will be insufficient to pay the expected claims.

Price Waterhouse report on estimated projected termination rates for the program's loans made in fiscal year 1996 can be used to calculate an estimated cumulative claim rate of about 10 percent over the life of the Title I loans insured by FHA in that fiscal year. Since the inception of the Title I program, about 27 percent of borrowers who have defaulted on their loans did so within 12 months of the loans' origination, while 58 percent defaulted within 24 months.

The number of consumer inquiries and complaints made nationally about home improvement contractors is significant. According to data compiled by the Washington, D.C., Metropolitan Area Better Business Bureau, in 1997 about 241,000 inquiries were made nationally about home improvement contractors, making it the second most often asked about industry. In addition, the Bureau received 6,829 consumer complaints nationwide about home remodeling contractors and another 4,452 about roofers in 1997, making those occupations fifth and eleventh in terms of the number of complaints.

In the last year, borrowers' allegations about shoddy and incomplete work by Title I dealers and possible fraud in the program have been the subject of media reports. In response to the media reports of abuses and excessive claims with the dealer-initiated loans, HUD proposed on July 3, 1997, to take steps that would eliminate this portion of the program. A decision on dealer loans had not been made as of June 25, 1998. However, in commenting on a draft of this report, HUD stated that it has sought public comment, through the rulemaking process, on whether and under what circumstances the dealer component of the program should be retained. In addition, in October 1997, HUD's Office of the Inspector General (OIG) reported on the results of its survey of the Title I property improvement program. The OIG's report concluded that the dealer portion of the program traditionally experienced higher claim rates and greater program abuse than the direct loan portion of the program.

Information Needed to Manage the Program Is Not Collected by HUD

HUD is not collecting the information needed to manage the Title I program. Specifically, we found that HUD (1) collects little information when loans are made on the borrowers, properties, and loan terms; (2) does not always have accurate data on the types of loans for which claims are submitted; and (3) does not maintain information on why it denies loan claims or why it subsequently approves some of them for payment. As a result, HUD cannot identify the characteristics of the borrowers and neighborhoods served by the program, nor can it accurately identify certain abuses of the program or default experience by loan types. Also, HUD has no basis for reviewing the reasonableness of decisions made to deny and subsequently approve claims.

HUD Collects Little Information on Borrowers, Properties, and Loans

When FHA-approved Title I lenders make program loans, they collect information on the borrowers, such as age, income, and sex; the property, such as its address; and the loan terms, such as the interest rate. While lenders are required to report much of this information to their respective regulatory agencies—such as the Federal Reserve System, the Office of the Comptroller of the Currency, and the National Credit Union Administration—under the Home Mortgage Disclosure Act,[6] HUD collects little of this information when Title I loans are made. Instead, using information that it requires lenders to provide, HUD records only the lender's and borrower's names, the state and county, as well as the amount, term, and purpose of the loan. Because it does not collect more detailed information, HUD cannot identify the characteristics of the borrowers and the neighborhoods served by the program, nor can it identify certain potential abuses of the program. Additional information that HUD collects on other single-family home loan insurance programs, such as the borrowers' addresses, Social Security numbers, income, and debt, is not collected by HUD when Title I loans are made. HUD does collect all of the information available on borrowers, property, and loans when Title I loans default and lenders submit claims. Title I officials told us they collect little information when loans were made because they consider the program to be lender-operated. In an August 1997 report on the Title I program, Price Waterhouse commented on the lack of data collected by HUD on this program and indicated that the cost of obtaining information would be marginal.

Because HUD does not collect borrowers' Social Security numbers and property addresses when loans are made, it would have difficulty determining whether some borrowers are obtaining multiple Title I loans. It would also have difficulty determining whether some borrowers are exceeding the maximum amount of Title I loans per property at the time new loans are made. The Title I statute limits the total amount of indebtedness on Title I loans to $25,000 for each single-family property.

In this regard, our examination of HUD's Title I claims data found a number of instances in which the same Social Security number was used for

[6]The act was enacted in 1975 to require some lending institutions to report various data about the loans, including applicant and borrower characteristics.

multiple claims. As discussed previously, claims on about 10 percent of the program's loans can be expected over the life of the loans. Our examination of 16,556 claims paid by HUD between January 1994 and August 1997 revealed 247 instances in which the same Social Security number appeared on multiple claims.[7] These cases totaled about $5.2 million in paid claims. In several instances, claims were paid on as many as five loans having the same Social Security number during the 3-1/2-year period. Our Office of Special Investigations, together with HUD's Office of the Inspector General, is inquiring further into the circumstances surrounding these loans. However, because these loans might have been for multiple properties, or were multiple loans on the same property that totaled less than $25,000, they might not have violated the program's statute. Allowing individual borrowers to accumulate large amounts of Title I HUD insured debt, however, exposes HUD to large losses if such heavily indebted borrowers default on their loans. In addition, while information available to HUD allows potential abuses of the $25,000 indebtedness limit to be identified after loans have defaulted, control over the indebtedness limitation is not possible for the 90 percent of the program's loans that do not default because HUD does not collect borrowers' Social Security numbers and property addresses when the loans are made.

A HUD official told us that in April 1998, HUD submitted a request to the Office of Management and Budget (OMB) to be allowed to collect additional information for the Title I program that would be similar to the information HUD collects on other FHA insurance programs for single-family home loans. The additional information HUD was seeking to collect includes the borrower's address, Social Security number, income, and debt. OMB's action on HUD's request was pending as of June 1998.

Also, in commenting on a draft of this report, HUD stated it had started the processes necessary to collect more data on each Title I insured loan. The amount of data collected will be increased significantly, and the method of collection converted from paper to electronic reporting by lenders, according to HUD. These changes will bring the data and reporting requirements for Title I loans more in line with the requirements for FHA's single-family mortgage insurance program, according to HUD. HUD has established a target date of 1999 for the implementation of these changes. Exhibits I and II of HUD's comments on a draft of this report, contained in appendix II, outline HUD's current and additional requirements for the data lenders are to submit.

[7]Appendix I describes our scope and methodology.

Information on Types of Loans for Which Claims Are Submitted Is Not Always Accurate

While HUD collects more extensive information on program loans when they default, we found problems with the accuracy of some of the information recorded in its claims database. Our random sample of 53 loans on which claims had been denied and then subsequently paid by HUD found that 7 loans, or 13 percent, had been miscoded as dealer loans when they were direct loans or vice versa.[8]

Accurate classification is important because HUD recently cited the high default rates on dealer loans, among other reasons, for proposing that the dealer loan portion of the program be eliminated. In a May 29, 1997, press release, the Secretary of HUD announced that a 4-month review of the Title I property improvement program found serious problems with the dealer portion of the program and that HUD was proposing that steps be taken that would eliminate dealer loans. Property improvement loans would still, however, be available directly from lenders. HUD has received various opinions about eliminating this portion of the program, but a final decision has not yet been made. Considering how many loans might have been miscoded as dealer or direct loans, we question HUD's ability to identify default experience by loan type. A Title I official told us that the miscoding was caused by lenders incorrectly reporting loan types and by HUD's contractors incorrectly entering these data in the database.

Information on Why Claims Are Denied and Subsequently Approved Is Not Maintained

HUD does not maintain information on why claims are denied or, for claims that were originally denied but subsequently paid, on why the claims were paid and which of the program's officials made the decision to pay them. HUD can deny claims for property improvement loans for a number of reasons, including missing documents, such as the original note, security instrument, or inspection report; failure to provide evidence of the borrower's legal interest in the property; poor underwriting; and misstatements, inconsistent data, or fraud. However, HUD does not have a system in place to provide information on why claims are denied or approved for payment following a denial. HUD could not provide us with information on how many claims it denied because of poor underwriting or other program abuses or on which lenders had a higher-than-average number of claims denied for specific program violations. In addition, we were unable to determine from HUD's data system why a denied claim was

[8]Our sample consisted of 39 dealer loans and 14 direct loans, from a universe of 3,161 dealer loans and 2,479 direct loans, as recorded in HUD's Title I database. We found that three (7.7 percent) of the loans classified as dealer loans were actually direct loans, and four (28.65 percent) of the loans classified as direct loans were actually dealer loans. Calculating a weighted average, so that dealer and direct loans in the sample matched their frequency in the population, produced an estimated error rate of 19.4 percent for the Title I database. The 95-percent confidence interval for the error rate on the dealer/direct classification extended from 4 to 35 percent.

subsequently paid following an appeal by the lender or a waiver by HUD. Such information is important in determining how well lenders are complying with the program's regulations, whether internal controls need to be strengthened, and which lenders should be targeted for review by HUD's Quality Assurance Division.

In addition, the files for claims that were initially denied by HUD and subsequently paid frequently did not contain the names of the program's officials who decided the denied claims should be paid and the reasons for their decisions. Of the 53 randomly selected loan claim files we examined, 50 contained no evidence of further review by a HUD official following the initial denial or did not provide any basis for eventually paying the claim.[9] Unless information about who makes decisions to deny claims and the reasons for the denials and the subsequent payments is documented, HUD has no basis for reviewing the reasonableness of those decisions.

In December 1997, HUD made changes to its claims database system so that it can identify the reasons for denying claims. The Title I program's officials agreed that such information is important in determining how well the program's regulations are being complied with and in targeting lenders for quality assurance reviews. Claims examiners are now required to identify their reasons for denying a claim, including the section of the regulation that the lender violated. However, HUD has not addressed the lack of documentation in the claim files explaining the reasons for paying claims that were previously denied.

HUD's Oversight of the Program's Lenders Is Limited

HUD's quality assurance reviews and its Title I claims examination process are the primary controls HUD has in place to ensure that lenders are complying with the program's regulations. However, the on-site monitoring reviews HUD conducted of lenders' compliance with the program's regulations have declined significantly over the last 3 years. According to HUD officials, fewer reviews were done because of limited staff resources and HUD's assignment of monitoring priorities. Moreover, some claim files do not contain complete information or are missing documents, which makes it difficult to determine why certain claims were approved for payment. As a result, HUD has little assurance that lenders are complying with the program's regulations.

[9] Using a weighted average, we estimate that there was no evidence of further review in about 91 percent of the loan files. Using a 95-percent confidence interval, we estimate that the percentage of files that contained no evidence of further review at between 79 and 100 percent.

HUD Monitors Few of the Program's Lenders

HUD's monitoring reviews of Title I lenders to identify compliance problems have declined substantially in recent years. During fiscal years 1995 through 1997, HUD performed 35 targeted, on-site quality assurance reviews of Title I lenders. Most of these reviews (26) were performed in fiscal year 1995. During fiscal year 1996, HUD performed five on-site reviews; during fiscal year 1997, it performed four.[10] According to HUD officials, HUD had a staff of 23 individuals to monitor the 3,700 lenders approved by FHA to make Title I loans and about 8,000 other FHA-approved lenders making loans under other FHA insurance programs. Because of its limited monitoring resources, HUD decided to focus on major, high-volume FHA programs, officials said. Monitoring priorities have also caused HUD to do few follow-up reviews to ascertain whether lenders had corrected deficiencies uncovered by the quality assurance reviews. As a result, it is difficult to determine what impact the quality assurance reviews that were performed might have had on improving lenders' compliance.

In addition to the targeted, on-site lender reviews, HUD also visited four lenders in Texas to examine and obtain information on the lenders' dealer loan case files. HUD conducted these reviews primarily in response to news stories by Texas reporters about dealers performing shoddy property improvement work. According to HUD officials, the reviews revealed instances of contractor fraud, flagrant program abuses, and noncompliance with the program's requirements. As a result, HUD headquarters issued limited denials of participation to 51 contractors. A limited denial of participation prohibits the recipient from participating in all FHA single-family housing programs nationwide for a period not to exceed 1 year.

Required Documents Are Missing From Loan Files

When making Title I loans, lenders are required to ensure that borrowers represent acceptable credit risks, having a reasonable ability to make payments on the loans, and to see that the property improvement work is completed. However, our examination of 53 loan claim files revealed that one or more of the required documents needed to ensure program compliance were missing from more than half (30) of the files.[11] Title I regulations do not require that a claim be denied if key documents, such as

[10]Although HUD conducted just four reviews in fiscal year 1997, it commented that the lenders reviewed accounted for over 35 percent of the 84,000 new Title I loans.

[11]We randomly sampled from the 5,640 program claims that were originally denied and then paid by HUD during the period from October 1994 through July 1997. Using a weighted average of direct and dealer loans, we estimate 49 percent of the loan files had missing program compliance documents. Using a 95-percent confidence interval, we estimate that the percentage of files with missing documents was between 30 and 68 percent.

an original loan application, certificate of completion, or inspection report, are not in the claim file. However, the program's regulations state that the Secretary of HUD may deny a claim for insurance in whole or in part if the program's regulations have been violated unless a waiver of compliance with the regulations is granted. HUD's claims examination manual states in the "Reasons for Denial" section that "a complete file consists of all documents relative to the processing and maintenance of the loan" and specifically lists missing inspection reports and completion certificates as reasons for denying a claim. According to a program official, for a claim to be paid on any property improvement loan with a principal balance of $7,500 or more, or on any direct loan without a completion certificate, the file must contain either (1) an inspection report showing that the work has been completed or (2) an inspection report, accompanied by a noncompliance letter, showing that the work has not been completed. In addition, a claim submitted after a default has occurred on a dealer loan should not be paid unless a signed completion certificate is in the file.[12] The 53 cases we examined were the official claim files maintained by HUD after claims were paid and should have contained all documents and other information related to the loans. HUD officials could not explain why key documents needed to ensure program compliance were missing from the files. Our review of the 53 cases revealed the following:

- In 12 cases, the required original loan applications, signed by the borrowers, were not in the loan files.[13] According to HUD's regulations, as part of the credit application process, the lender must obtain a separate, dated loan application on a HUD-approved form. Title I regulations require that the loan application and all other documents supporting the lender's decision that the borrower is an acceptable credit risk be retained in the loan file. The original loan application is important because it is used by the claims examiner to review the adequacy of the lender's underwriting and to ensure that the borrower's signature and Social Security number match those on other documents, including the credit report.
- In 20 cases, the required completion certificates certifying that the property improvement work had been completed were missing or were

[12]In commenting on a draft of this report, HUD reiterated that the omission of a particular document from a claim file may not warrant denial of the claim. We agree. As pointed out in this paragraph, for example, while the program's regulations always require a completion certificate for a dealer loan, it is not required for direct loans if the lender conducts an on-site inspection of the completed work.

[13]In commenting on a draft of this report, HUD pointed out that it can pay claims when original documentation is missing and that lenders can be in substantial compliance with the agency's regulations if they submit facsimile or other documents. In our review, we considered facsimiles of completion certificates and inspection reports in the loan files as adequate documentation to support the payment of the claims. However, we considered the omission of the original loan applications from the files as inadequate documentation because HUD's claims examination manual requires the original loan applications to be in the files.

signed but not dated by the borrowers. We found that completion certificates were missing, or not dated, for 17 dealer loans and 3 direct loans. Title I regulations require that the lender obtain a completion certificate signed by the borrower certifying that the work has been completed. This requirement differs for dealer and direct loans. A completion certificate is always required for a dealer loan because under Title I regulations, loan funds cannot be disbursed until the lender has obtained a signed certificate certifying that the work has been completed. For a direct loan, the program's regulations require that the borrower submit a signed completion certificate to the lender within 6 months after the loan proceeds are disbursed, with one 6-month extension if necessary. If a borrower fails to provide the completion certificate within the required 12-month period, lenders are required to conduct an on-site inspection of the completed work. Thus, it is permissible under the program's regulations for a direct loan file not to contain a certificate of completion if the file instead contains an inspection report showing that the lender, after not receiving the certificate, conducted an inspection.

- For 33 loans for which the program's regulations required that inspections be conducted by the lenders, 19 loan files did not contain the inspection report. Once work has been completed and loan funds have been disbursed, Title I regulations require that the lender inspect the work paid for by any property improvement loan with a principal amount of $7,500 or more or by any direct loan for which the borrower failed to provide a completion certificate. The purpose of the inspection is to verify that the improvements are eligible for Title I loan insurance and to confirm that the work has, in fact, been completed. If the borrower refuses to cooperate with the lender in permitting the inspection, the lender must promptly report this fact to HUD.

Lenders Do Not Always Comply With the Program's Regulations

We also reviewed the 53 claim files to determine how well lenders were complying with underwriting standards. According to the program's regulations, a Title I lender should exercise prudence and diligence in determining whether the borrower (and any co-borrower) is solvent and an acceptable credit risk, with a reasonable ability to make payments on the loan obligation. All documentation supporting the underwriting determination should be retained in the loan file, according to HUD's regulations. HUD can deny a lender's claim if the lender has not followed HUD's underwriting standards in making the loan. However, HUD does not examine the quality of a lender's loan underwriting during the claims process if the borrower made 12 loan payments before defaulting on the loan. Since 27 percent of the Title I loans that default do so within the first year, this practice, in effect, exempts the majority of defaulted loans from an examination of the quality of the lenders' underwriting. Of the 53 loans in our sample, 13 defaulted within 12 months of the loan's origination and were subject to an underwriting review by HUD. We focused our underwriting examination on the claim files for these 13 loans.

We found that for 4 of the 13 loans on which HUD eventually paid claims, lenders made questionable underwriting decisions. The Title I program's regulations require that the credit application and the review by the lender must establish that the borrower is an acceptable credit risk, has 2 years of stable employment, and has an income that will be adequate to meet the periodic payments required by the loan, along with the borrower's other housing expenses and recurring charges. However, information in the claim files for these four loans indicated that the borrowers might not have had sufficient income to qualify for their loans or had poor credit. For example, on one loan, the lender used a pay stub covering the first 2 weeks of March to calculate the borrower's annual income. The pay stub showed that the borrower's year-to-date earnings were $6,700 by the middle of March, and this amount was used to calculate that his annual income was $34,000, or about $2,800 per month. But the pay stub also showed that for a 2-week period in March, the borrower worked a full week with overtime; the borrower's usual earnings were about $1,600 per month. The file contained no other documentation, such as income tax returns, W-2 forms, or verification from the employer to support the higher monthly income. The program's officials told us that it was acceptable to use one pay stub to calculate monthly income but that the "yearly earnings to date" figure should not be used because it can at times overstate the actual income earned during a normal pay period. The borrower, with about $1,600 per month in corrected income, still met HUD's income requirements for the amount of the loan. However, HUD denied the lender's original claim because its underwriting standards had not been followed in that the borrower had poor credit at the time the loan was made. In a letter responding to HUD's denial of its claim, the lender acknowledged that the borrower had limited credit at the time the loan was made, but pointed to the (miscalculated) higher income of $2,800 per month to justify making the loan. This reasoning was apparently accepted by HUD as there was no evidence in the claim file that HUD questioned the error in calculating the borrower's monthly income. The borrower defaulted on the loan after making two payments, and HUD paid a claim of $14,000.

The Claims Examination Process Is HUD's Primary Control Over the Quality of the Lenders' Underwriting

The number of quality assurance reviews being conducted by HUD of Title I lenders has declined significantly in the last few years. In addition, the quality assurance staff does not collect data on lenders whose loans go into default within 2 years after the loans' origination date. As a result, HUD's claims examination process has become the primary tool available to ensure that lenders are underwriting loans properly. As noted earlier, however, HUD does not examine the lenders' underwriting on the majority of defaulted Title I loans (73 percent) because the defaults occurred 12 months after the date of the loans' origination. In addition, Title I program officials stated that lenders will, at times, make additional payments for the defaulted borrowers to move the default date beyond the 12-month cutoff date to avoid underwriting reviews.[14] In contrast, for its single-family mortgage insurance program, FHA considers any loan for which foreclosure occurs within 18 months of the loan's endorsement date to be an indicator of potentially unsound underwriting practices (e.g., lending to unqualified borrowers).[15] Since 31 percent of Title I loans default between the 13th and 24th month after the loans' origination, increasing the review period from 12 to 24 months after origination would result in over half of all defaulted Title I loans being subjected to underwriting reviews by HUD. Increasing the number of defaulted Title I loans subjected to underwriting reviews before insurance claims are paid would provide added incentive for lenders to properly underwrite Title I loans and could reduce HUD's exposure to financial losses.

HUD Has Found Similar Problems With Lenders' Noncompliance

HUD itself has identified similar problems with lenders' noncompliance with the Title I program's regulations. As noted previously, during fiscal years 1995 through 1997, HUD performed 35 on-site quality assurance reviews of Title I lenders. Among other things, HUD cited lenders for engaging in poor credit underwriting practices and for having loan files that were missing inspection reports or that included inspection reports that were not signed or dated. HUD sent the lenders letters detailing its findings and requesting written responses addressing the findings. HUD, however, did not perform follow-up, on-site reviews on 34 of the lenders to ensure that they had taken corrective actions. As a result of the 35 on-site

[14]The officials were not certain about how often this occurs. Our examination of default dates showed no grouping of defaults at the 13- to 14-month period, which would seem to indicate that this may not be a common practice. However, 31 percent of Title I loans default between the 13th and 24th month after the loans' origination, and making even an additional 8 to 10 payments on a large loan may be worth it to a lender when the alternative is to have a $15,000 or $25,000 claim denied for poor underwriting.

[15]After making a mortgage loan on a single-family home, a lender seeks FHA's approval to insure the loan. The date when FHA formally approves mortgage insurance for the loan is termed the "loan endorsement date" and occurs sometime after the date of the loan's origination.

reviews, nine lenders were referred to HUD's Mortgagee Review Board for further action.[16] The Board assessed four of these lenders a total of $23,500 in civil penalties.[17]

Market Incentives Could Increase Lenders' Compliance With the Program's Regulations

HUD contracted with Price Waterhouse to obtain information on the Title I program and on options for improving the program's management. Information reported by Price Waterhouse in its August 1997 study of the Title I program suggests ways to restructure the program by giving lenders greater incentives to comply with the program's regulations. One option discussed in the report would be to reduce the portion of losses FHA insures on an individual defaulted Title I loan to less than the current 90 percent. Another option would be to set a cap on allowable interest rates to some level above the prevailing rate on U.S. Treasury bonds. Each of these options would increase the amount of risk lenders are exposed to and provide greater incentives for them to do a better job in the underwriting and servicing of Title I loans. At the same time, however, it is likely that some potential Title I borrowers would be adversely affected since they would be judged by lenders as being too risky to participate in the program under the new guidelines. Given the lack of historical information on Title I borrowers and loans, we were unable to estimate the likely impact of these options on the program's participants or on the participation of lenders.

Reducing Title I Insurance Could Increase Incentives for Lenders to Comply With the Program's Regulations

The Title I program is a coinsurance program, with HUD insuring 90 percent of the unpaid principal balance and uncollected interest, plus uncollected legal fees on individual loans. According to Price Waterhouse, the level of risk lenders bear has not been great enough in recent years to force lenders to lend and service loans in a prudent fashion. As a result, the program's current risk-sharing structure has failed to protect FHA from losses in excess of premium revenue, according to the Price Waterhouse report.

One way to increase incentives for lenders to improve the originating and servicing of loans is to reduce the insurance coverage on individual claims. While reducing coverage would increase incentives for lenders to be prudent, it may also reduce lending to the riskiest borrowers served by the

[16]The HUD Reform Act of 1989 (12 U.S.C. 1708) and implementing regulations established the Mortgagee Review Board within FHA to take actions against HUD-approved mortgagees, including Title I lenders who do not comply with HUD requirements.

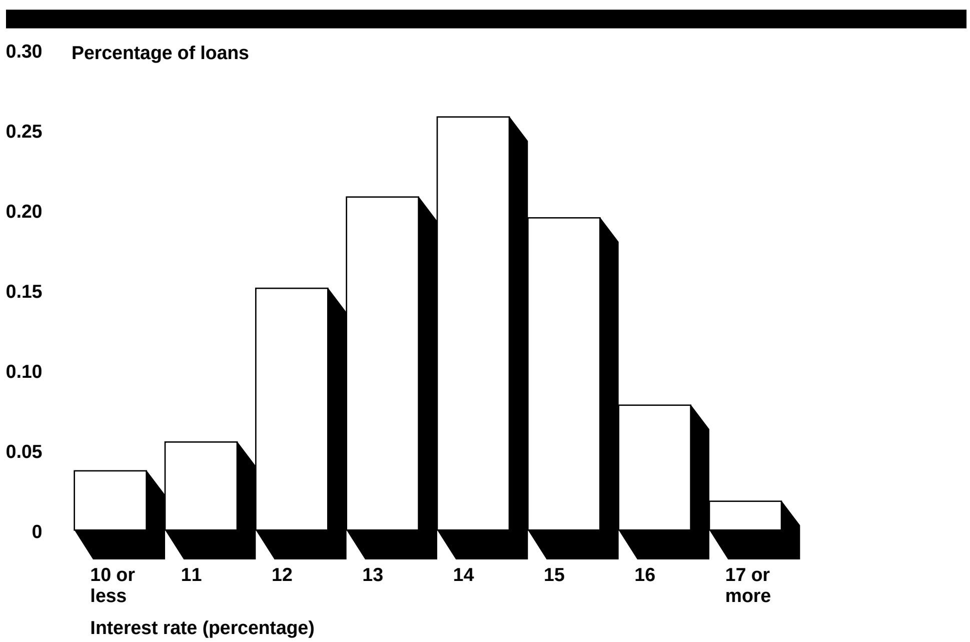
[17]During this period, the Board also took administrative actions against 28 other Title I property improvement lenders and assessed some of them a total of $249,500 in civil money penalties for violating the program's regulations.

program. It is also possible that some lenders may stop making Title I loans. Given the limited data available on Title I borrower demographics and loan characteristics, we could not estimate the impact that this change would have on the program's participants or on the participation of lenders in the program.

Capping Interest Rates Could Reduce Lenders' Incentive to Make Risky Loans

Title I loans are often made with interest rates above those for mortgages on single-family homes. Price Waterhouse surveyed lenders in June and July 1997 and found that Title I lenders charged interest rates ranging from 9 to 18 percent. These rates were substantially above the 8-percent mortgage interest rate that prevailed at that time, but in line with the 8- to 18-percent rates charged on conventional home improvement loans. Our examination of interest rates on 12,477 loans on which claims were submitted by lenders to HUD during the period from January 1995 through August 1997 found interest rates as high as 21 percent. The typical loan's interest rate was in the range of 12 to 16 percent (see fig. 1).

Figure 1: Distribution of Interest Rates on Defaulted Title I Loans



Capping interest rates on Title I loans could reduce the profitability of lending to risky borrowers and help FHA reduce its losses. Currently, lenders may find it profitable to originate risky loans if, on the loans that succeed, they generate revenues high enough to more than offset the losses they sustain on loans that terminate in claims. Price Waterhouse's report on the Title I program suggests capping interest rates as one way of discouraging risky lending. The report also notes that it would be necessary to cap points and origination fees as well as interest rates because points and fees are a part of the lenders' total yield on the loans. Such a policy change would reduce both lenders' interest in the program and their willingness to lend to the riskiest borrowers.

HUD Is Changing the Title I Program

Under HUD's 2020 Management Reform Plan and related efforts, the agency has been making changes to the Title I program's operations. HUD has relocated its claims examination unit to the Albany (New York) Financial Operations Center and has contracted with Price Waterhouse to develop claims examination guidelines. According to the program's officials in Albany, the new claims process will be more streamlined and automated and will allow lenders to file claims electronically. In addition, HUD is consolidating all single-family housing operations from 81 locations across the nation into four Single-Family Homeownership Centers. Each center has established a quality assurance division to (1) monitor lenders; (2) recommend sanctions against lenders and the program's other participants, such as contractors and loan officers; (3) issue limited denials of participation against program participants; and (4) refer lenders for audits or investigations. However, since HUD's quality assurance staff will monitor lenders involved in all FHA single-family housing programs, the impact of this change on improving HUD's oversight of Title I lenders is unclear. Overall, by the end of fiscal year 1998, the quality assurance staff will have increased to 76, up from 43 in February 1998. The quality assurance staff has conducted four on-site reviews of Title I lenders since October 1, 1997. HUD expects that the addition of more quality assurance staff will increase the number of lenders being reviewed, including Title I lenders, and allow more comprehensive reviews of lenders' operations.

Conclusions

Weaknesses exist in HUD's management of its Title I property improvement loan insurance program and in its oversight of the program's lenders. These weaknesses center on the absence of information needed to manage the program and HUD's oversight of lenders' compliance with the program's regulations. As a result, HUD does not know who the program is serving, whether lenders are complying with the program's regulations, or whether certain potential program abuses are occurring, such as violations of the $25,000 limit on the amount of Title I loan indebtedness allowed for each property. The challenge faced by HUD in managing and overseeing this program centers on how to obtain the information needed to manage the program and to strengthen the oversight of lenders for what is a relatively small program compared with other FHA housing insurance programs.

We concur with HUD's decision to seek approval to collect additional information on the Title I program's borrowers, properties, and loans at the time that loans are made. Given the small cost of obtaining this information, we are optimistic that HUD's downsizing will not impede this effort. Similarly, restructuring the Title I program by providing lenders with greater incentives to comply with the regulations could improve HUD's oversight of the lenders without significantly diverting HUD's monitoring resources from high-volume FHA loan insurance program lenders. Unless HUD improves its management information and oversight of the Title I property improvement program and provides lenders with greater incentives to comply with the program's regulations, it will continue to have little assurance that the program is operating efficiently and free of abuse.

Recommendations to the Secretary of HUD

To promote effective management and accountability in the Title I program, we recommend that the Secretary of HUD direct the Assistant Secretary for Housing-Federal Housing Commissioner to do the following:

- Improve the information available to manage the program by ensuring that information on the types of loans made is accurate and recorded correctly in HUD's data systems.
- Improve the Title I claims examination process by ensuring that (1) the documents included in the claim files clearly explain why a claim that was originally denied was subsequently paid and which program official authorized payment; (2) all documents required by the program's guidelines and regulations, including the original loan application, inspection report, and completion certificate, are contained in the claim application package before a claim is paid; (3) the number of claims subject to an underwriting review is increased by extending the length of time after origination during which loan defaults are subjected to review, with notification of this change sent to lenders in writing; and (4) procedures are developed to routinely provide the Quality Assurance

Division with the information collected during the claims examination process that is needed to monitor and target lenders for review.

Agency Comments and Our Evaluation

We provided HUD with a draft of this report for their review and comment. (See app. II.) HUD agreed with our recommendations aimed at ensuring that information on the types of loans made is accurate, increasing the number of claims that are subject to an underwriting review, and using information collected during the claims examination process to monitor and target lenders for review. It also pointed out actions it has under way or planned to implement these recommendations. On our remaining recommendations, HUD commented that its Albany staff already documents claim files to justify payment decisions and who made them and requested a list of the 53 claims we reviewed to better understand and respond to our recommendation that all required documentation be obtained before a claim is paid.

While we did not review claim files processed by HUD's Albany office because this office had assumed responsibility for claims only shortly before our review began, we remain concerned about the extent of the documentation of payment decisions in HUD's Albany office claim files. Albany Title I officials told us in February 1998, shortly after they began processing claims, that they were unsure what documentation they would consider necessary for lenders to submit beyond that needed to ensure a loan's enforceability (that is, HUD's authority to recover the amount of the loans and related costs from a borrower who defaults on the loan). These officials stated that the Albany staff's primary focus is to pay claims. In response to HUD's request, on June 11, 1998, we provided a list of the 53 claim cases we had reviewed to HUD's Albany office.

We conducted our review from November 1997 through June 1998 in accordance with generally accepted government auditing standards. The details of our scope and methodology are presented in appendix I.

We are sending copies of this report to the appropriate Senate and House committees; the Secretary of HUD; and the Director, Office Management and Budget. We will make copies available to others upon request.

Please call me at (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix III.

Judy A. England-Joseph
Director, Housing and Community
Development Issues

Contents

Abbreviations

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
OIG	Office of the Inspector General
OMB	Office of Management and Budget

Scope and Methodology

To determine whether HUD has the information it needs to manage the Title I program, we reviewed Title I legislation in the National Housing Act and the program's guidelines and procedures. We also interviewed HUD officials who are responsible for the Title I program's operations, lender monitoring, and claims examinations and program guidance. We examined two computerized files, one of loan originations endorsed and the other of claim payments made from fiscal year 1986 through fiscal year 1996. We also examined 16,556 computerized files of loan claim payments paid by HUD from January 1994 through August 1997 to determine if any multiple claims were submitted on the same borrower for the same property.

To determine the extent to which HUD was overseeing the program's lenders, we interviewed Title I officials at headquarters and the Denver Homeownership Center responsible for monitoring lenders, staff of HUD's Mortgagee Review Board, and claims examination officials at HUD headquarters and at the Albany (New York) Financial Operations Center. We also interviewed officials of the association that represents many of the Title I lenders for their views on the adequacy of HUD's lender monitoring. We examined HUD's quality assurance case files for the lenders it monitored during fiscal year 1995 through fiscal year 1997 and the files for those Title I lenders who had action taken against them by the Mortgagee Review Board for violating the program's requirements. We also interviewed the staff from Price Waterhouse who are assisting the Title I program's claims examination unit in preparing new procedures.

From 5,640 program claims that were originally denied and then paid by HUD during the period from October 1994 through July 1997, we obtained a random sample of 53 loan claims to review the required documents and underwriting decisions. Because we used a probability sample to develop our estimates, each estimate has a measurable precision, or sampling error, which may be expressed as a plus/minus figure. A sampling error indicates how closely we can reproduce from a sample the results that we would obtain if we were to take a complete count of the universe using the same measurement methods. By adding the sampling error to and subtracting it from the estimate, we can develop upper and lower bounds for each estimate. This range is called a confidence interval. Sampling errors and confidence intervals are stated at a certain confidence level—in this case, 95 percent. For example, a confidence interval, at the 95-percent confidence level, means that in 95 out of 100 instances, the sampling procedure we used would produce a confidence interval containing the universe value we are estimating.

With the exception of verifying the sample on the types of loans made, we did not independently verify the accuracy or test the reliability of HUD's data. We did perform tests to check the interval consistency of the data and worked with agency officials to ensure that we interpreted the data properly.

To determine whether options and information presented by Price Waterhouse in its HUD-commissioned study of the Title I program could provide lenders with greater incentives to improve loan underwriting and servicing, we reviewed Price Waterhouse's report of August 1997 and the program's regulations that influence loan risk. We also examined 12,477 computerized files of claims submitted by lenders for payment to HUD during the period January 1995 through August 1997 to determine what interest rates lenders charged borrowers. Given the limited data available on Title I borrower demographics and loan characteristics, we were unable to estimate the likely impact of these options on the program's participants or on the participation of lenders in the program.

Our information on the efforts HUD plans or has under way to strengthen the program's management and oversight was obtained through interviews with HUD officials in charge of the Title I program, reviewing HUD's 2020 Management Reform Plan, and reviewing Price Waterhouse's August 1997 report on the program.

Comments From the Department of Housing and Urban Development

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

JUN 25 1998

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy England-Joseph
Director
Housing and Community
Development Issues
General Accounting Office
441 G Street N.W., Room 2056
Washington, DC 20548

Dear Ms. England-Joseph:

Thank you for the opportunity to comment on the proposed audit report HOME IMPROVEMENT: Weakness in HUD's Management and Oversight of the Title I program (GAO/RCED-98-216). HUD agrees with GAO's finding that the Title I program is in need of major reforms. The Department is engaged in a comprehensive review of the program and contemplates enacting major program changes within the next several months.

The Title I program is HUD's oldest mortgage insurance program. Over the years it has benefited millions of American families, ensuring that their homes are in safe and sanitary conditions. Nonetheless, we share GAO's concerns about the program and are using its findings in our ongoing effort to improve the program.

As reflected in our responses below, to GAO's specific recommendations, HUD is taking concrete steps to improve administration of the Title I program. However, as noted above, HUD is also conducting a major internal review of the program and is considering substantial program reform. As part of this latter process HUD sought public comment, through the rulemaking process, on whether and under what circumstances the dealer component of the program should be retained.

FINDINGS BY THE GAO

GAO concluded that HUD is not (1) collecting sufficient information to adequately manage the program and (2) providing enough oversight of claim payments to Title I lenders.

GAO's RECOMMENDATIONS AND THE DEPARTMENT'S RESPONSE

The Department is largely in agreement with GAO's findings and conclusions. GAO has made the following recommendations that HUD take action:

To improve the information available to manage the program by ensuring that information on types of loans made is accurate and recorded correctly in HUD's data systems.

HUD's Response

HUD has already started the processes necessary to collect more data on each insured loan. The amount of data collected will be increased significantly and the method of collection converted from paper to electronic reporting by lenders. Among other things, lenders will be required to report who is servicing each loan, and to provide additional data on loans that are more than 90 days in default. These changes will bring the data and reporting requirements for Title I loans more in line with the requirements for FHA's Single Family first mortgages. A target date of 1999 has been established for implementation of these changes. For your information, I have enclosed Exhibits I and II which outline the current and additional lender data submission requirements, respectively.

HUD has also already started one process of improving data quality. The Department's Chief Financial Officer is coordinating a HUD-wide data clean-up effort for elements that will feed the Community 2020 data base and the new Integrated Financial System that includes Title I data. An assessment of the identified Title I elements will be completed this fiscal year and an action plan developed. Lenders will be reminded of the need to report accurate data on each loan and a data quality plan will be implemented.

To improve the Title I claims examination process by ensuring that documents included in the claim files clearly explain why a claim that was originally denied was subsequently paid and which program official authorized payment.

HUD's Response

The General Accounting Office review focused exclusively on claim files processed by the HUD Headquarters Title I claims examination unit. Previous to this review, the Department recognized the need for changes in its Title I claims examination process. To meet this need, the Department relocated its claims examination unit to the Albany Financial Operations Center. The Albany Center has the ability to dedicate adequate staff resources and management oversight to the claims examination functions. The Albany staff already documents the claim files to justify payment decisions and who made them. Additionally, the Department is now developing a process to improve the structure of approving appeal and waiver requests from lenders.

To improve the Title I claims examination process by ensuring that all documents required by the program's guidelines and regulations, including the original loan application, inspection report, and completion certificate, are contained in the claims application package before a claim is paid.

HUD's Response

The need for complete inclusion of documentation in insurance files cannot be overstated. HUD's Title I staff is aware of the emphasis being placed on comprehensive recordkeeping and taking actions in compliance with our objective. Proper documentation is a critical feature of the program. Ensuring that essential documents are in the file will be a component of our improved claims process.

In order to better evaluate and respond to this particular GAO recommendation, HUD is requesting a list of the cases GAO reviewed. It should be noted, however, that HUD's regulations allow the Department to pay claims where original documentation is missing if the lender is in substantial compliance with the program's guidelines and regulations. A lender may be in substantial compliance by submitting facsimile documents or other justification. Moreover, a particular omission may not warrant denial of a claim. For example, if the Completion Certificate is not in the file on a direct to borrower loan, but the lender has inspected the property and the inspection revealed that all improvements were done, the absence of the completion certificate would not prohibit the payment of the claim. The Albany Center already documents the claim files to justify these payment decisions and who made them.

To improve the Title I claims examination process by ensuring that the number of claims subject to an underwriting review is increased by extending the length of time after origination during which loan defaults are subjected to a review, with notification of this change sent to lenders in writing.

HUD's Response

The Department agrees with the recommendation to increase the number of claims subject to an underwriting review. In deciding upon the appropriate number of reviews, HUD is evaluating the impact of this change on staff resources and claim review timeliness before implementation.

To improve the Title I claims examination process by ensuring that procedures are developed to ensure that information collected during the claims examination process that is needed to monitor and target lenders for review is routinely provided to the Quality Assurance Division.

HUD's Response

The Department is developing several ways to ensure that Title I data, including the data collected during the claims review process, is made available to the lender monitors in the Quality Assurance Division of each Homeownership Center. The primary method will be the addition of the Title I data on a monthly basis to the Single Family Data Warehouse. This information can then be assessed by lender monitors as well as other Departmental staff. The first phase of these changes will begin before the end of the year and be fully implemented in 1999.

Secondly, the day to day management of the lender monitoring function has been decentralized from HUD Headquarters to the four Homeownership Centers. This decentralization allows for better and more localized targeting of lenders and facilitates better management and oversight of a vastly larger population of outstationed monitors.

The Department will continue to target lenders for review based on their performance and volume. In 1997, reviews were conducted on the majority of the ten highest volume lenders who reported new Title I loans. The reviewed lenders accounted for over 35% of the 84,000 new Title I loans. Lenders are also targeted for review based on specific reports about their compliance with the program regulations from various sources, including borrowers, other lenders, the Inspector General and the general public.

CONCLUSION

Thank you again for the opportunity to comment on the draft report. Improving the Title I program is a matter of high priority for the Department. We welcome your suggestions and cooperation towards this objective. If you or your staff should need additional information, please feel free to call me at (202) 708-3600.

Sincerely,

Art Agnos
Acting General Deputy Assistant
Secretary for Housing-Federal
Housing Commissioner

Enclosure

EXHIBIT 1

1. Current Information Collected on Title I Loans when the Loans are reported for Insurance

Loan
- Lender Reporting the Loan
- Institutional Loan Number (lender's loan number)
- Loan Amount
- Date of Loan Disbursement
- Date of First Payment
- Number of Payments to Maturity
- Payment Mode (Monthly, Quarterly, Annually, etc.)
- Name of Dealer if a Dealer Loan

Property Improvement
- Type of Structure (Single Family, Multifamily, Non-Residential, etc.)
- Type of Improvement (Exterior Finishing, Structural Addition, etc.)

Borrower
- Name
- Race

Property Location
- State
- County

EXHIBIT II

2. Additional Information to be Collected

Type of Data	Data Fields
Loan	Interest Rate Originating Lender ID Discount Points Owner/Occupied (Y/N) Lien Position Dealer/Contractor Name Dealer/Contractor Tax ID Repaired by Borrower (Y/N)
Property Improvements	Reason for Improvements Cost of Improvements
Borrower (s)	Name of 1st Borrower Name of 2nd Borrower Sex Social Security Numbers Incomes Dates of Birth Marital Status Self Employed (Y/N)
Property Location	Street City State Zip MSA Code Census Tract
Default Information (reported on all loans over 90 days delinquent)	Servicer's Contract Number Oldest Unpaid Installment Loan Status Loan Status Date Bankruptcy Status Bankruptcy Date Cause of Default

Major Contributors to This Report

Stanley Czerwinski
Sherrill Dunbar
Austin Kelly
Robert Procaccini
Phillis Riley
Patrick Valentine

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