United States General Accounting Office

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Report to the Chairman, Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services, House of Representatives

June 1999

HOMEOWNERSHIP

Problems Persist With HUD's 203(k) Home Rehabilitation Loan Program

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General Accounting Office
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Resources, Community, and Economic Development Division

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June 14, 1999

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

Dear Mr. Chairman:

The 203(k) Home Rehabilitation Mortgage Insurance program was established to help promote the rehabilitation and repair of the nation's housing stock through a program that combines, in one insured mortgage, the funds needed to purchase and rehabilitate a single-family home. 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 a borrower defaults and the lender subsequently forecloses on the loan, the lender can file an insurance claim with HUD for nearly all of its losses. Over the past 4 years, reports of abuses within the 203(k) program have raised serious concerns about HUD's management of it. Collectively, these reports—by HUD's Inspector General and others—indicate that the 203(k) program is highly vulnerable to waste, fraud, and abuse.

Because of your concerns with HUD's management of the program, you asked us to determine (1) the risk the 203(k) program poses to FHA's insurance fund[1] relative to the 203(b) program,[2] (2) HUD's efforts to correct program deficiencies identified by HUD's Inspector General and others, and (3) weaknesses, if any, in HUD's oversight of the 203(k) program and the extent to which lenders are complying with HUD's underwriting guidelines for making program loans. We have also provided information on the growth in the program, the performance of the program's loans overall and by borrower type, and the customers served by the program. (See app. I.)

To address these issues, we focused on the activities of HUD's headquarters and its four Homeownership Centers located in Santa Ana, California;

[1]Loans under the 203(k) Home Rehabilitation Mortgage Program are insured by FHA's General Insurance Fund, which provides for a number of specialized mortgage insurance programs.

[2]FHA provides most of its single-family mortgage insurance through the 203(b) program, which covers loans for purchasing a new or existing one-to four-family home. Loans under the 203(b) program are insured by FHA's Mutual Mortgage Insurance fund. In fiscal year 1998, loans worth over $90 billion were insured under the 203(b) program.

Denver, Colorado; Atlanta, Georgia; and Philadelphia, Pennsylvania. Each of these centers is responsible for the general management of the program in its region. We also reviewed reports and recommendations by HUD's Inspector General, KPMG Peat Marwick, and HUD management. We compared the 203(k) program with the 203(b) mortgage insurance program because the 203(b) program is FHA's largest single-family mortgage insurance program and HUD oversees both programs in the same manner.

Results in Brief

The 203(k) loan program is more risky than HUD's largest single-family loan program—the 203(b) program—because it combines the risk of a traditional mortgage with the risk of a construction loan. For loans endorsed[3] from fiscal years 1994 through 1996,[4] the claim rate[5] for loans made under the 203(k) program is almost double that of loans made under the 203(b) program. In addition, HUD projects that while loans made under the 203(b) program in fiscal year 1994 through fiscal year 1998 will make money for the Mutual Mortgage Insurance Fund, it projects that 203(k) loans will cost the General Insurance Fund—that is, claims and other costs will exceed premiums and other income by over $25 million.[6] This cost represents approximately .7 percent of the total amount insured by the program, as of the end of fiscal year 1998. HUD stated that it finds this loss rate to be expected for a home rehabilitation program. Figure 1 illustrates the expected losses from loans endorsed in fiscal years 1994 through 1998.[7]

[3]After making a loan to a borrower, a lender seeks FHA's approval to insure the loan. When FHA formally approves mortgage insurance for the loan, it is considered "endorsed."

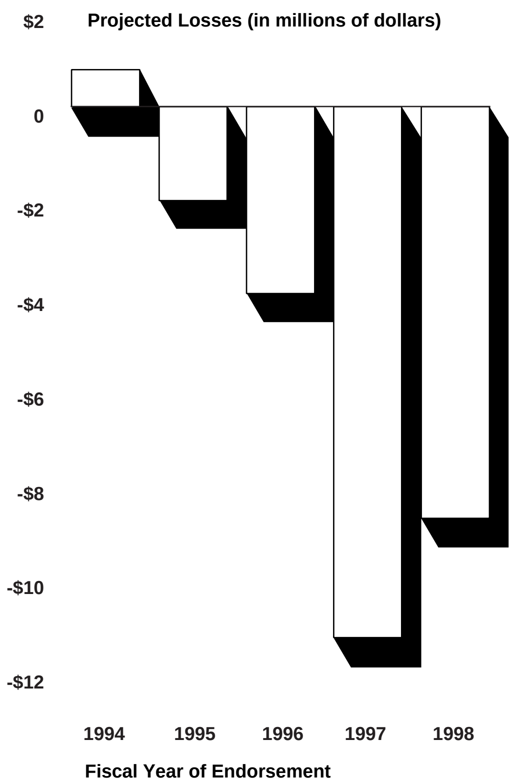
[4]These are the most recent years with sufficient data to establish claim rates.

[5]A claim rate is the percentage of loans endorsed in a specific year that result in a claim being filed against the insurance fund.

[6]This figure represents the net present value of current and future projected losses.

[7]Program losses are expressed in fiscal year 1999 dollars.

Figure 1: Projected Losses to the General Insurance Fund for 203(k) Loans Made in Fiscal Year 1994 Through Fiscal Year 1998, Dollars in Millions



Source: GAO's analysis of HUD's data.

Figure 1 shows that anticipated losses will increase from approximately $2 million for loans endorsed in fiscal year 1995 to over $11 million for loans endorsed in fiscal year 1997.

Despite the recognized risk associated with the 203(k) program and the potential for mounting losses to the General Insurance Fund, HUD has done little to address the problems identified by its Inspector General and others. In the past 4 years, reports by HUD's management, HUD's Inspector General, and others have repeatedly cited problems and weaknesses in the management of this program, indicating that it is highly vulnerable to waste, fraud, and abuse. For example, HUD's Inspector General reported that the program design encourages risky property deals and overstated property appraisals and does not adequately safeguard HUD's interests.

Furthermore, in its review of a sample of loans made to investors and nonprofit organizations, the Inspector General found that many of the homes had not been properly rehabilitated. Although HUD's management has, for the most part, agreed with the findings as reported, it has done little to address the problems. The most recent study of the program—completed in October 1998 by outside contractors—found that the Department had done little to address the long term viability of the program and recommended that HUD radically redesign or eliminate it.

HUD is not adequately overseeing key aspects of the 203(k) program. With respect to lenders, HUD's Homeownership Centers do not adequately ensure that lenders are complying with the program's guidelines. At the four Homeownership Centers, we found that 203(k) loans were not targeted for review to ensure that the lenders are properly administering them. In one center, HUD management made a conscious decision not to review 203(k) loans because it lacked trained staff. Furthermore, HUD does not properly train and monitor 203(k) home inspectors and consultants, who are responsible for designing and overseeing the home rehabilitation process. We also found cases in which the agency failed to address consultants' abuses or incompetence. For example, we found incidences in which a consultant who was also an inspector approved payments for work by contractors that was either not completed or was completed improperly. Furthermore, HUD still does not adequately ensure that nonprofit organizations comply with HUD guidelines for participating in the program.

This report makes recommendations designed to improve HUD's management and oversight of the 203(k) program.

Background

The 203(k) Home Rehabilitation Mortgage Insurance program[8] is HUD's primary program for rehabilitating and repairing single-family homes. A single loan insured under the 203(k) program can be used to both purchase and rehabilitate a home. The 203(k) program, like other FHA programs, insures mortgage loans to encourage lenders to make loans available to borrowers who would not otherwise qualify for conventional loans on affordable terms. Eligible borrowers may include the owner/occupant, nonprofit organizations, and until October 1996,

[8]The Rehabilitation Home Mortgage Insurance program was authorized by section 203(k) of the National Housing Act, as amended.

investors.[9] The General Insurance Fund supports the 203(k) program as well as other specialized housing programs.[10] Unlike the Mutual Mortgage Insurance Fund, which supports the 203(b) program, the General Insurance Fund is not intended to be self-sustaining. When the General Insurance Fund incurs losses, funds are appropriated by the Congress. As of fiscal year 1998, HUD had about $3.6 billion in insurance on 44,000 outstanding 203(k) loans.

The 203(k) program allows borrowers to finance both the purchase or refinancing of a house and the cost of its rehabilitation through a single mortgage or to finance the rehabilitation of their existing home. When buying a house that is in need of repair or modernization, homebuyers not using the 203(k) program often must follow a complicated and costly process: They must obtain financing to purchase the property, get additional financing to rehabilitate it, and find a permanent mortgage after rehabilitation is completed to pay off the interim loans. The interim acquisition and improvement loans often have relatively high interest rates and short repayment terms. However, the 203(k) program helps both borrowers and lenders by insuring a single, long-term, fixed- or adjustable-rate loan to cover the costs of both the acquisition and the rehabilitation. A loan insured under the 203(k) program also protects a lender by allowing it to have the loan insured for the full value of the rehabilitated home before the rehabilitation process begins.

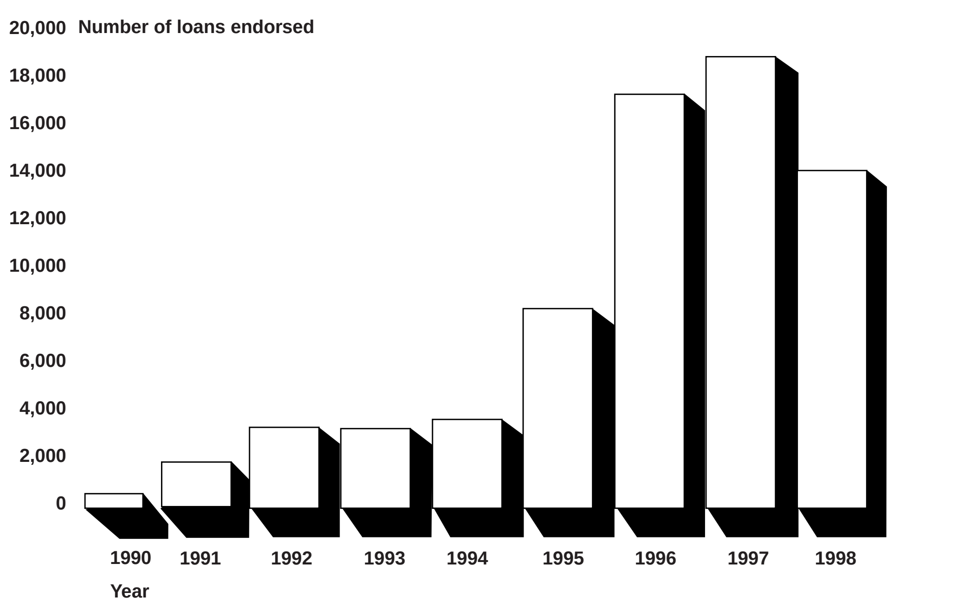
Compared with other FHA mortgage loan programs, such as the 203(b) program, the structure of the 203(k) program is far more complex. Like the 203(b) program, the 203(k) program provides mortgage insurance to protect lenders against the risk of default on loans to qualified buyers and may be used to finance the purchase of single-family housing as well as to refinance debt. The completion of a 203(k) loan, however, involves multiple entities and estimates. At closing, a lender must set aside the estimated funds to pay for the rehabilitation in an escrow account. A HUD-approved consultant is often needed to determine the extent of work that must be done to rehabilitate a property and the estimated cost of that work. A HUD-approved inspector is needed to monitor the progress of the rehabilitation and to co-sign with the borrower any request of escrow funds. HUD guidelines allow the consultant to also function as the inspector. The procedures for the loan application and rehabilitation process are discussed in appendix II.

[9]Because of abuses by investors in the program, a moratorium on investor participation was implemented in October 1996.

[10]The General Insurance Fund provides for a large number of specialized mortgage insurance programs, including insurance for loans for condominiums, land development, and nonprofit hospitals.

For fiscal year 1994 through fiscal year 1998, HUD endorsed 62,757 loans for 203(k) insurance, with more than 80 percent of the endorsements made in fiscal years 1996 through 1998. (See fig. 2.) Although the 203(k) program was established in its present form in 1978, HUD began promoting and streamlining it in 1994 to make it more acceptable to lenders and borrowers, and by 1995, program use had noticeably increased. Since March 1994, HUD has made a number of changes to the 203(k) program to make it more user-friendly for lenders and borrowers. These changes were also made to streamline and shorten the processing time for 203(k) loans. For example, in an effort to streamline the process, HUD eliminated the requirement for lenders to submit change orders to the HUD field office for an extension of time to complete improvements. In 1995, HUD made additional changes to the program that were recommended by a working group that consisted of HUD offices, lenders, nonprofit organizations, and government agencies. The changes included (1) making the HUD offices responsible for ensuring that consultants are properly trained and (2) allowing consultants to serve as inspectors in order to reduce the processing time of a 203(k) loan.

Figure 2: Number of 203(k) Loans Endorsed, Fiscal Years 1990-98



Source: GAO's analysis of HUD's data.

The management and oversight of the 203(k) program is distributed among headquarters staff and the Department's four regional Homeownership Centers in Philadelphia, Pennsylvania; Atlanta, Georgia; Denver, Colorado; and Santa Ana, California. Each regional Homeownership Center is responsible for the operation of the 203(k) program in its territory. These responsibilities include processing and underwriting; lender monitoring; marketing; and customer assistance. In 1994, FHA's Office of Housing began consolidating some of its mortgage insurance processes from its 81 field offices into the four Homeownership Centers in order to provide faster processing. With the exception of a few field offices that have not transferred to the Homeownership Centers, the reorganization is complete.

Program Design and Performance Demonstrate a High Degree of Risk

The 203(k) program's design, as well as its past performance, indicate that future claims from defaulted loans may lead to losses to the General Insurance Fund. As a result of HUD's streamlining of the program in 1994, the value of insured 203(k) loans grew from just under $400 million in fiscal year 1994 to almost $3.6 billion in fiscal year 1998, an increase of about 835 percent. Because of the program's complex design and relatively high claim rate, this increase in the dollar amount of loans insured has increased the risk of loss to the federal government. After deducting premiums paid and other income, HUD projects that net losses to the General Insurance Fund will exceed $25 million from loans made during fiscal years 1994 through 1998. These losses represent approximately .7 percent of the total amount insured by the program, as of the end of fiscal year 1998. HUD stated that this loss rate is to be expected for a home rehabilitation program.

Program Design Poses Risk to the General Insurance Fund

The process for approving and disbursing 203(k) loans is far more complex than the processes for other FHA-insured single-family lending programs. The complexity stems from the rehabilitation component of the program, which (1) places far greater emphasis on estimates, reports, and opinions; (2) has more individual steps required in the underwriting and funding process; (3) involves multiple participants; and (4) requires a greater sophistication on the part of the borrower. Both internal and outside reviews of the 203(k) program have found that the program's design presents a high degree of risk to the Department and the General Insurance Fund. In a February 1997 report on the program,[11] HUD's

[11]Audit Report: Section 203(k) Rehabilitation Mortgage Insurance Program (HUD/OIG 97-AT-121-0001,Feb. 6, 1997).

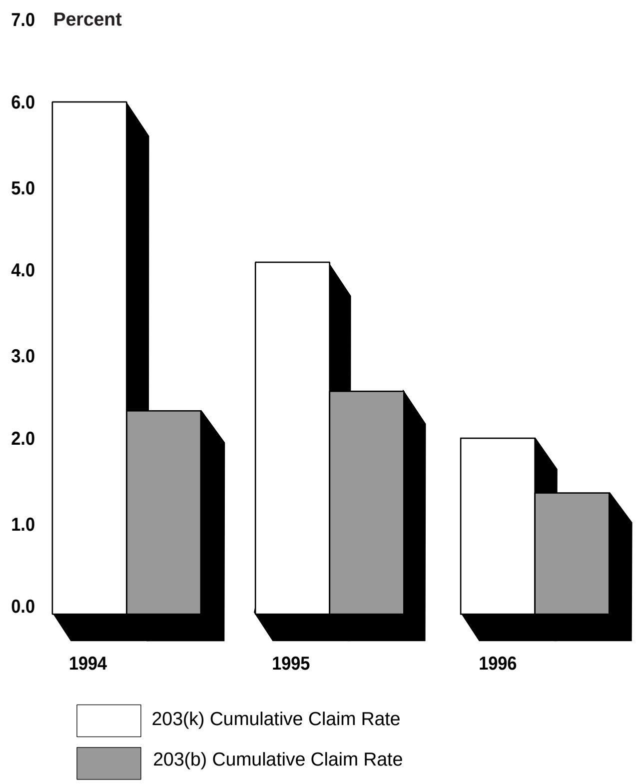
Inspector General concluded that the program design does not adequately safeguard HUD's interests. The report stated that the program design encourages risky property deals, overstated property appraisals, and phony or excessive fees. Furthermore, an internal HUD study of the 203(k) program reported that because the loan program is designed to let borrowers purchase and rehabilitate property, it poses multiple inherent risks, including the failure to complete work in an acceptable manner and to accurately estimate the cost of rehabilitation. In an October 1998 draft study,[12] HUD contractors asserted that, by virtue of its complexity, the 203(k) program poses a high risk of loss to the Department and that this risk has been reflected in high default and claim rates.

Past Performance of 203(k) Program Indicates It Poses an Increasing Risk of Loss

The performance of loans made under the 203(k) program is poorer than that of loans made under HUD's 203(b) program. For loans endorsed during fiscal year 1994 through fiscal year 1996—the most current years with sufficient data to determine meaningful claim rates—the cumulative claim rates through 1998 for 203(k) loans are almost double the rates for 203(b) loans made in the same years. (See fig. 3.)

[12]KPMG/META's Front End Risk Assessment (FERA)-Section 203(k) Rehabilitation Mortgage Insurance Program, Oct. 23, 1998. HUD officials told us they consider this study to be a draft until they issue a written response to it.

Figure 3: Cumulative Claim Rates Through 1998 for the 203(k) and 203(b) Programs for Loans Endorsed in Fiscal Years 1994-96



Note: Cumulative claim rates are total claims to date for a specific year of loan endorsements, as of Sept. 30, 1998.

Source: GAO's analysis of HUD's data.

Figure 3 shows that cumulative claim rates for the 203(k) program are consistently higher than those for the 203(b) program for the years shown. For example, as of September 30, 1998, the cumulative claim rate for 203(k) loans endorsed in fiscal year 1994 was 6.1 percent, while the claim rate for 203(b) loans endorsed in the same year was 2.4 percent.

Furthermore, HUD projects that the 203(k) program will incur net losses for loans endorsed in each of fiscal years 1995 through 1998, while the 203(b) program is projected to incur net gains for the same period. For example, the projected net loss, as a percent of endorsements, for 203(k) loans made in fiscal year 1997 is .75 percent of the total amount of endorsements in that year. The projected net gain for 203(b) loans made in that year, as a percent of endorsements, is 1.7 percent.

According to HUD, the projected net loss/gain for the General Insurance Fund for the 203(k) program is expected to go from a surplus of $810,000 for loans endorsed in fiscal year 1994 to a deficit of $11.6 million for loans endorsed in fiscal year 1997. This is in contrast to the 203(b) program, for which HUD projects each year's loans will add economic value to the Mutual Mortgage Insurance Fund.

Performance Indicators Suggest Cumulative Claim Rates May Increase Significantly

The cumulative claim rates of loans made under the 203(k) program will most likely increase. The recent growth in the 203(k) program, its historical pattern of claim rates, and an increase in early default rates,[13] suggest that the percentage of loans resulting in claims for the 203(k) program will increase in the next few years.

At least 75 percent of the loans endorsed under the 203(k) program since fiscal year 1994 were made in the past 3 years. According to an external review of historical and projected claim rate data for HUD-insured loans,[14] during the 1990s the percentage of 203(b) loans resulting in claims is at its highest in the fourth and fifth year after the loans were endorsed. If this pattern holds for 203(k) loans, and it has so far, claim rates for loans endorsed in fiscal year 1996 through fiscal year 1998 will continue to increase over the next 4 years, resulting in increasing claim outlays. The review also found that the claim rate begins to decrease in the sixth year and beyond. For instance, as of fiscal year 1995, only 5 of the approximately 3,700 loans made under the 203(k) program in fiscal year 1994 had resulted in a claim against the General Insurance Fund, a cumulative claim rate of .1 percent. By fiscal year 1998, 235 additional claims were filed against the fund from loans made in fiscal year 1994, and the cumulative claim rate for these loans grew to approximately 6.5 percent.

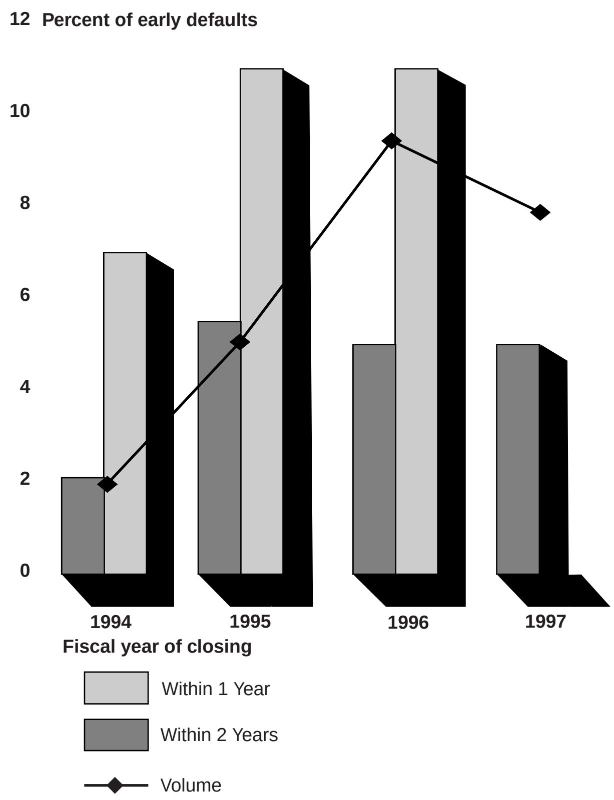
While the 203(k) program was growing by over 800 percent, the early default rate was increasing. HUD tracks the early default rates of 203(k) loans by lender to determine how well lenders are underwriting them. This rate was about 2.3 percent for 203(k) loans made in fiscal year 1994,

[13]Early defaults are all loans that have defaulted within 1 year of loan closing. A mortgage loan is considered in default when the borrower misses three consecutive monthly payments.

[14]Price Waterhouse, An Actuarial Review for Fiscal Year 1998 of the Federal Housing Administration's Mutual Mortgage Insurance Fund, Final Report, Mar. 1, 1999.

5.5 percent for fiscal year 1995 loans, and 5.2 percent for fiscal year 1996 and fiscal year 1997 loans.

Figure 4: Early Default Rates for 203(k) **Program for Loans Endorsed in Fiscal Years 1994 Through 1997**



Source: GAO's analysis of HUD's data.

According to HUD, an early default rate is a good indication of a lender's underwriting quality and the likelihood that a loan will result in a claim against the insurance fund. A HUD official added that loans that default within 12 months after they are endorsed frequently have serious underwriting problems associated with them.

HUD Management Has Done Little to Address Recognized Problems in the 203(k) Program

Despite the risk of loss the 203(k) program poses to the General Insurance Fund, HUD management has done little to address problems with the program identified by both internal and external reviews over the past 4 years. These reviews indicate that the program is highly vulnerable to fraud, waste, and abuse and make a number of recommendations to strengthen the program. Although HUD's management has agreed with these reports and indicated a willingness to implement most of the recommendations, it has failed to do so in many cases.

HUD Management Fails to Adequately Address Problems Identified by the Inspector General

Reporting on the results of a 3-year review in February 1997,[15] HUD's Inspector General stated that the involvement of investors and nonprofit organizations in the 203(k) program increased HUD's risk of loss to the General Insurance Fund from defaults. Many of the homes covered by the loans the Inspector General reviewed had not been properly rehabilitated. The report concluded that the program design encourages risky property deals and overstated property appraisals and does not adequately safeguard HUD's interests. The Inspector General made several recommendations for improving the program, such as permanently barring investors from the program to curb their abuses. The Inspector General added that anything less than a permanent ban was unacceptable because of the substantial waste, fraud, and abuse that the review had discovered.

In addition, in an August 1997 report, the Inspector General concluded that HUD had no effective criteria for approving consultants[16] and consultant trainers and recommended that HUD develop uniform criteria.

In May 1998, the Inspector General commented positively on owner-occupant participation in the program but expressed concerns about lenders' performance. Auditors found problems with the underwriting in 40 of the 50 loans they reviewed. For example, several of the lenders were approving borrowers who did not meet the eligibility criteria for 203(k) loans. The Inspector General found that HUD needed to take steps to ensure more effective lender performance in originating loans and administering the rehabilitation process.

Although it formally agreed to implement most of the Inspector General's recommendations in these reports, HUD has failed to do so. For example,

[15]Audit Report: Section 203(k) Rehabilitation Mortgage Insurance Program (HUD/OIG 97-AT-121-0001, Feb. 6, 1997).

[16]Consultants are responsible for preparing work write-ups and cost estimates and generally overseeing the rehabilitation process to protect the interests of the borrower.

the Inspector General had recommended that HUD develop written criteria for approving and training 203(k) program consultants. In response, in an October 1997 memorandum, HUD stated that it would develop a national certification examination for consultants. According to a senior HUD official, HUD has no plans in the near future to contract for, or otherwise develop, this examination.

HUD management has taken some steps in response to the Inspector General's findings to minimize the program's exposure to fraud, waste, and abuse. For instance, in October 1996, HUD placed a moratorium on investor participation in the program. HUD has issued several other policy directives clarifying for lenders the Department's policy related to, among other things, lender underwriting and the disbursal of funds. HUD has also eliminated certain provisions, such as providing FHA insurance on 203(k) second mortgages, which placed HUD at unacceptable risk.

In addition, in 1997, HUD developed a draft policy directive designed to help curb fraud and abuse by program participants. The draft directive proposes several changes to the program, including limiting the number of properties that nonprofit organizations can purchase under the program and imposing stricter requirements for approving these organizations. Although the policy was to be effective in October 1997, the directive was never issued because the Acting Housing Commissioner was hesitant to make changes to the program until a permanent Housing Commissioner was appointed. The permanent Housing Commissioner was appointed in October 1998.

HUD Fails to Take Action on Problems Identified by Independent Studies

In October 1998, the contractors hired by HUD to study the 203(k) program reported that the Department has done little to reduce the risks associated with the program, and hence, its long-term viability.[17] Specifically, the draft report identified six major risks associated with the 203(k) program: (1) program complexity, (2) insufficient lender monitoring, (3) inadequate guidance concerning consultants, (4) hesitant management direction, (5) increased loss potential from nonprofit organizations, and (6) low program volume. The contractors reported that continued inaction on the part of HUD management will likely contribute to a downward trend in the performance of the program, putting it in jeopardy. The contractors recommended that HUD either eliminate the program or radically redesign

[17]KPMG/META, Front End Risk Assessment (FERA)- Section 203(k) Rehabilitation Mortgage Insurance Program, Oct. 23, 1998. HUD officials told us they consider this study to be a draft until they issue a written response to it.

it. They added that unless HUD can devote the resources to the program to properly manage it, the program should be eliminated.

Responding to the contractors' study, HUD indicated that it would not take immediate action to correct the problems identified. According to the Acting Director of Single-Family Housing, the new FHA Housing Commissioner, who took office in October 1998, has been devoting most of his attention to addressing issues in programs that are much larger in scope and volume than the 203(k) program. According to this official, when resources are freed from addressing these other programs, management would probably prepare a comprehensive plan to improve the 203(k) program.

HUD's Oversight of the 203(k) Program Is Inadequate

HUD provides little direct oversight over the 203(k) program. We identified three areas of particular concern. HUD is not (1) targeting the 203(k) program for oversight, (2) properly training and overseeing consultants and home inspectors, and (3) adequately monitoring nonprofit organizations' participation in the program.

HUD Does Not Target the 203(k) Program for Oversight

Although HUD recognizes the program's unique risks and potential for abuse, it has not targeted the 203(k) program to minimize those risks. Instead, HUD oversees the 203(k) program using the same approach it uses to oversee the less-risky single-family insurance programs, such as HUD's 203(b) Home Mortgage Insurance Program. For these programs, HUD's four Homeownership Centers conduct post-endorsement technical reviews and quality assurance reviews, which are HUD's primary means to oversee lenders.

HUD has not used post-endorsement technical or quality assurance reviews effectively to minimize the unique risks posed by the 203(k) program. Post-endorsement technical reviews are desktop audits of a sample of loan cases that have already been endorsed for insurance by FHA. These reviews are designed to determine the quality of a lender's underwriting of an endorsed loan. For example, the reviewer will ensure that all required loan application documents were obtained or completed by the lender and that these documents were properly signed. Quality assurance reviews occur at a lender's place of business. Trained HUD staff perform in-depth reviews of troubled loans and evaluate a lender's internal control system for originating FHA-insured loans.

We found that 203(k) loans, although recognized as being high-risk, are not targeted for these reviews. HUD officials told us that they plan to start targeting 203(k) loans for review this year. We also found that the detailed results of the post-endorsement reviews are placed in the loan file; they are not given to the lender. Twice a year, HUD sends the ratings from the post-endorsement reviews to the lenders but does not specify why they were assigned a given rating. As a result, HUD and the lenders cannot take action on any problems identified in the review process in a timely manner.

HUD officials told us that while they do not target 203(k) loans for review, they do perform quality assurance reviews on lenders that make these loans. Since January 1, 1996, HUD has performed 52 quality assurance reviews on lenders that make 203(k) loans. Seventeen of these reviews were on lenders that made over 100 203(k) loans during that period. However, HUD could not provide information on how many 203(k) loans may have been reviewed.

HUD has emphasized increasing the number of 203(k) loans endorsed by streamlining the program, but it has not committed the resources needed to adequately oversee the program. Officials at two Homeownership Centers told us that they do not have staff qualified to do quality assurance reviews for 203(k) loans. According to an official at a Homeownership Center responsible for 17 states, the Center did not have sufficient travel funds to adequately oversee any of its single-family programs, including the 203(k) program, during the first quarter of fiscal year 1999.

HUD Is Not Properly Training and Overseeing Consultants and Home Inspectors

We found that HUD has no uniform criteria for training, approving, and evaluating the performance of consultants and inspectors who participate in the 203(k) program. Consultants and inspectors can be used, interchangeably, to perform home inspections, identify health and safety problems, and provide descriptions of the work to be performed and cost estimates for the buyers. In addition to having at least 3 years of specialized experience, consultants/inspectors must receive training in the 203(k) program. However, at two of the four centers we visited, HUD had not provided any training to 203(k) consultants/inspectors and had not taken any action to evaluate the performance of approved consultant/inspectors. One of the other centers provided minimal training, such as holding training sessions via teleconference, but had not taken any action to evaluate the performance of approved consultants. According to a HUD official, many consumer complaints about the program result from the work of consultants and inspectors.

We also found cases in which the agency failed to address consultants' abuses or incompetence. For example, according to customer complaints we reviewed, a Chicago consultant/ inspector allowed a contractor to receive thousands of dollars for work the contractor either did not do or did not do adequately. In a request for payment, the consultant/inspector approved payments to the contractor for a ceiling installation that was never completed. Figure 5 shows the incomplete ceiling.

Figure 5: Incomplete Ceiling and Light Fixture Installation

Source: GAO.

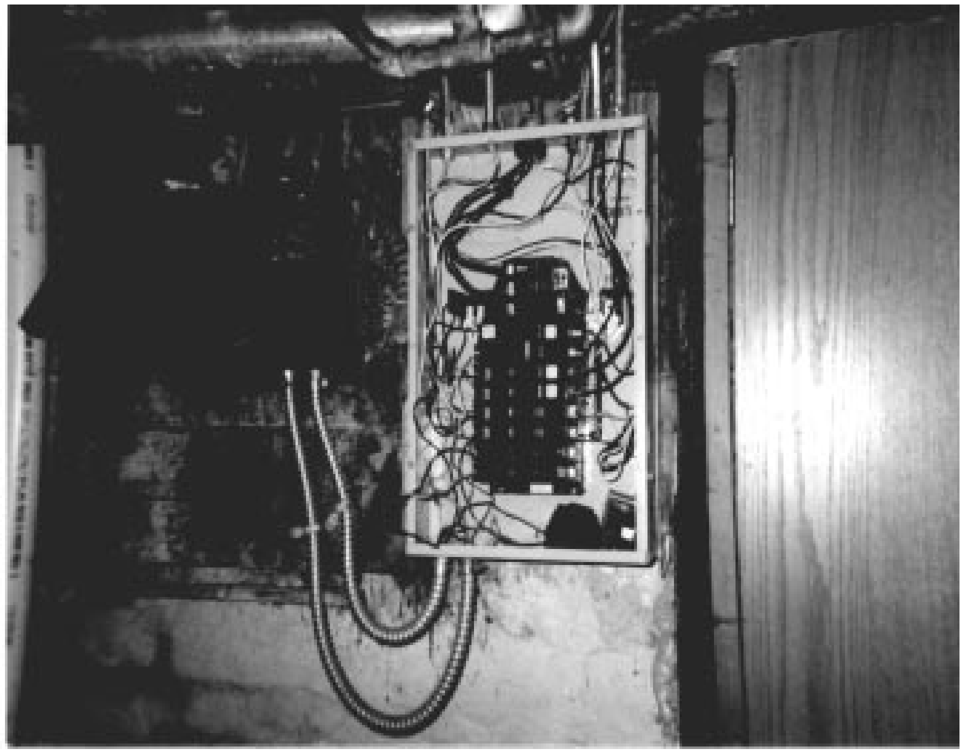
The same inspector reported that plumbing work had been completed. Figure 6 shows that this was not the case.

Figure 6: Incomplete Plumbing Work

Source: GAO.

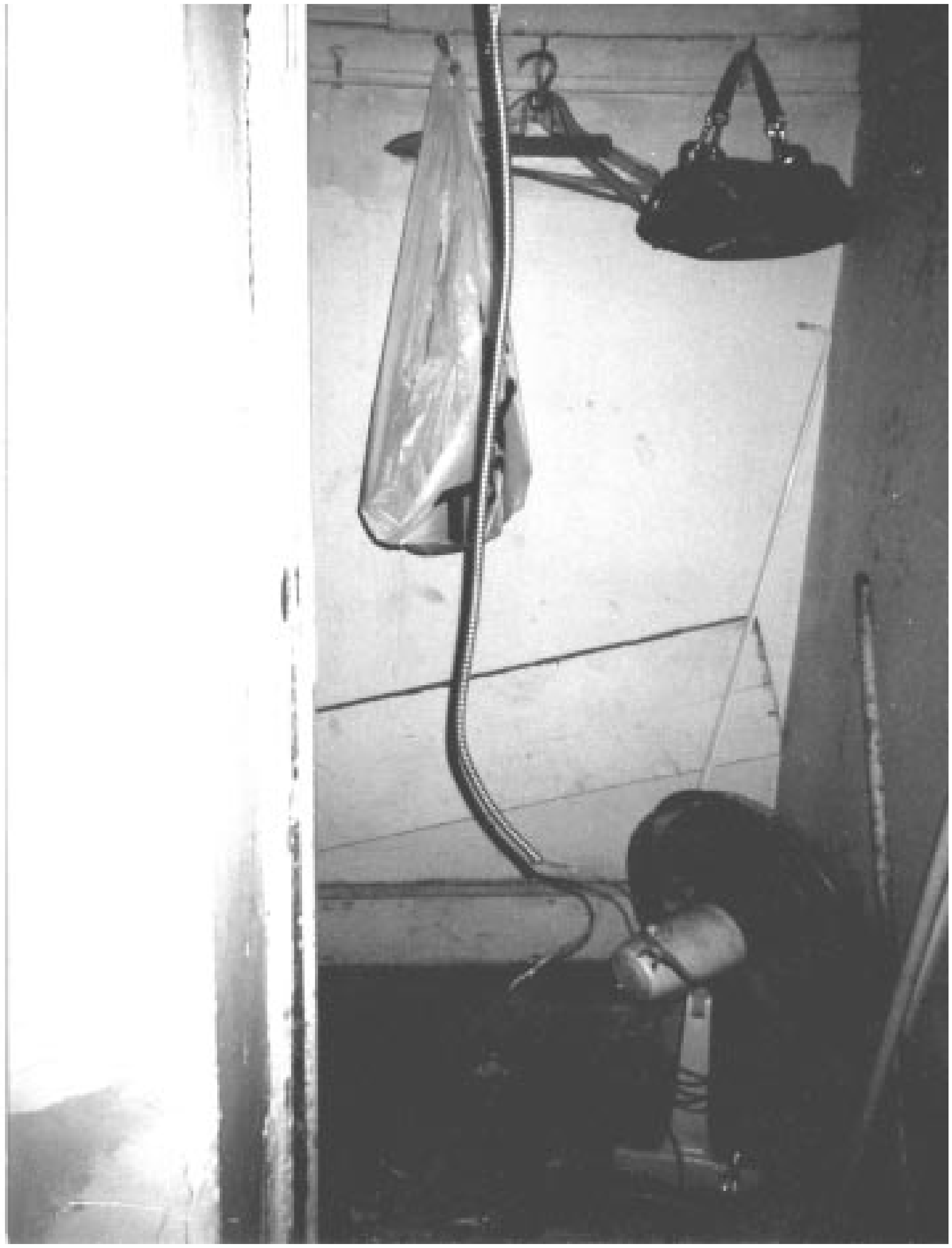
Figures 7 through 9 show incomplete electrical work in another Chicago home that was recorded as completed.

Figure 7: Exposed Breaker Box and Wires Connected to an Old Breaker Box



Source: GAO.

Figure 8: Hanging Electrical Wires in Closet



Source: GAO.

Figure 9: Electrical Wiring Strung Along Outside of Wall Instead of Inside the Wall

Source: GAO.

Similarly, in a recent report, HUD's Inspector General found that a Michigan HUD field office failed to take action against a consultant who the office knew was either incompetent or was abusing the program. This consultant was the exclusive consultant/inspector for four of the largest 203(k) lenders in the area.

HUD Is Not Adequately Monitoring Nonprofit Organizations' Participation in the Program

HUD has failed to properly monitor the participation of nonprofit organizations in the 203(k) program. HUD guidelines require that the Homeownership Centers recertify nonprofit organizations every 2 years. At three of the four centers we visited, we did not find evidence that the centers had recertified any of the approved nonprofit organizations for the program.

While they represent only about 5 percent of the 203(k) program's loan volume, nonprofit organizations' participation is just as problematic as investors' participation. Nonprofit organizations' claim rate, on average, is more than double that of any other borrower type in the 203(k) program, including investors. For fiscal years 1994 through 1998, the claim rate for nonprofit organizations was 6.3 percent, whereas the claim rate for investors and owner/occupants was 2.7 percent and 1.2 percent, respectively.

In 1997, the Inspector General reported that nonprofit organizations presented the same level of risk to the program as investors and that their participation in the program has failed to achieve HUD's objectives. Nonprofit organizations' 203(k) loans are so risky and problematic that one of the largest lenders of funds for the program decided to no longer make or purchase 203(k) loans. According to a senior official at this lender, most of the nonprofit loans the bank acquired have eventually gone into default.

To illustrate how nonprofit organizations can abuse the program, a HUD official told us that a group of investors agreed to pay a nonprofit organization to obtain mortgages under the 203(k) program on their behalf. The nonprofit organization was to be paid for each mortgage it obtained and for each property the investors rehabilitated and sold. When the investors were unable to successfully rehabilitate these properties, the organization defaulted on all of the mortgages it had taken out and the properties went into foreclosure. When we attempted to determine whether the nonprofit organization met HUD's criteria for participation in the program, we discovered that the local field office could not locate its records on approved nonprofit organizations in its area. Therefore, HUD officials were uncertain as to whether the organization was even approved for the program.

Conclusions

The 203(k) program's design, coupled with its rapid growth and past performance, pose a risk of loss to the government. Because of the program's complexity, it is important that HUD aggressively oversee the program. HUD, however, has been in a reactive mode since the program began to grow rapidly. Because of reports issued over the last 4 years by HUD's Inspector General and others, HUD is fully aware of the weaknesses in the program but has done little to correct them. The program's recent performance as well as management's continued inaction suggest that the program will continue to pose a risk of loss to HUD's $3.6 billion portfolio of 203(k) loans. Outside contractors have recently suggested that HUD either eliminate the program entirely or radically redesign it to mitigate future losses to the General Insurance Fund.

HUD has not used its primary oversight methods—post-endorsement technical reviews and quality assurance reviews—to target 203(k) lenders or loans. Although HUD has identified the 203(k) program as one of its riskiest, it has failed to devote sufficient resources to oversee the program. This failure to target the 203(k) program has allowed those participants who pose a risk to remain in the program.

Furthermore, HUD does not have a uniform training program for consultants and inspectors. Most of the complaints that HUD receives from 203(k) borrowers are the result of consultants/inspectors' not adequately ensuring that the rehabilitation work performed by contractors is adequate. The borrower often depends on the consultant/inspector to ensure that the work is properly completed and meets contractual requirements. Incomplete or improper rehabilitation can leave the home uninhabitable and can ultimately lead to foreclosure.

Finally, serious concerns have been raised by HUD's Inspector General concerning the continued participation of nonprofit organizations, particularly the problems associated with their loan underwriting and loan administration. Waste, fraud, and abuse in the 203(k) program by nonprofit organizations will most likely continue unabated if HUD continues to fail to scrutinize their qualifications and operations.

Recommendations

In order to provide the necessary management and oversight of the 203(k) program, we recommend that the Secretary of Housing and Urban Development direct the Assistant Secretary for Housing—Federal Housing Commissioner to take the following actions:

Improve the post-endorsement technical review to identify lenders' underwriting violations before the program incurs losses as a result of poor underwriting. Lenders should also be notified immediately of underwriting violations and be required to rectify the violation or risk losing HUD's insurance on the loan.

Recognizing the risk inherent in the program, target high-risk 203(k) lenders for routine Quality Assurance Reviews to minimize the risks that these lenders pose to the General Insurance Fund.

Establish strict criteria to ensure that consultants/inspectors are well versed in residential construction/rehabilitation and cost estimating to protect the interests of the borrower.

Establish strict criteria for qualifying and recertifying nonprofit organizations for their continued participation in the program to ensure they have the resources and the expertise to rehabilitate properties.

Agency Comments

We provided a draft of this report to the Department of Housing and Urban Development for its review and comment. In commenting on a draft of this report, the Department agreed that lenders with poor underwriting practices should be targeted for enforcement actions, but it did not agree with our approach of improving the post endorsement review process to mitigate losses. The Department believes that its new Credit Watch system will identify lenders with unusually high loan default and claim rates. The Credit Watch system is designed to terminate poor-performing lenders or place them on probation, which results in heightened scrutiny of their performance. We do not agree that the Credit Watch system will improve the post endorsement technical review process, which identifies underwriting violations early in the life of the loans to mitigate potential losses before they occur. Although the Credit Watch system may identify poor-performing lenders, it does not address how the Department would better communicate the results of the post endorsement technical review to lenders to ensure that underwriting violations are corrected expeditiously. Therefore, we made no change to this recommendation.

The Department also agrees that high-risk lenders should be targeted for extra monitoring activities. However, it did not comment on our recommendation of targeting 203(k) lenders for routine quality assurance reviews. In response to this recommendation, HUD stated that its new Credit Watch system will result in a heightened level of review and monitoring for 203(k) lenders. Accordingly, we did not change this recommendation.

In response to our recommendations to establish criteria for consultants, home inspectors, and nonprofit organizations participating in the 203(k) program, HUD agreed that the consultants' role needs to be reassessed and will be considered as part of the Department review of the 203(k) program. HUD will also take into consideration our recommendation to improve qualifying standards for nonprofit organizations.

In addition to its comments on our recommendations, HUD took exception to our comparison of the 203(k) program with the Federal Housing Administration's 203(b) loan insurance program, stating that the 203(k) program is known to be inherently riskier. We compared the two programs to highlight this inherent risk and to demonstrate the need to devote resources to oversee the 203(k) program. Furthermore, we recognize in the report that, while the 203(k) program is inherently risky because of the construction component of the loan, HUD oversees both programs in essentially the same way. In addition, HUD states that it includes 203(k) lenders in its targeting of lenders for review. We do not disagree that the Department has reviewed 203(k) lenders, but HUD could not tell us the extent to which the lenders' 203(k) activity was reviewed.

HUD's comments and our detailed response are presented in appendix IV.

We conducted our review from May 1998 through May 1999 in accordance with generally accepted government auditing standards. Our scope and methodology are discussed in detail in appendix III.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from the date of this letter. At that time, we will send copies of this report to Representative Barney Frank, Ranking Minority Member, House Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services. We will also send copies of this report to the Honorable Andrew M. Cuomo, the Secretary of Housing and Urban Development; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will make copies available to others on request.

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

Sincerely yours,

Stanley J. Czerwinski
Associate 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

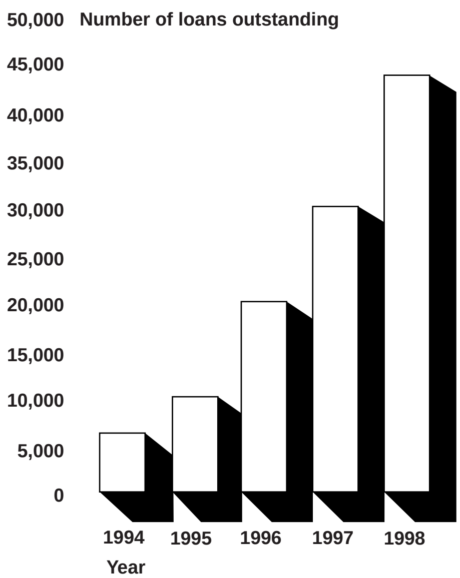
203(k) Program Data, Fiscal Years 1994 Through 1998

This appendix presents information on the 203(k) Home Rehabilitation Mortgage Insurance program for fiscal years 1994 through 1998. It provides data on the growth in the program, the value and number of loans, types of lenders, and the customers served by the program.

203(k) Program Has Grown Substantially

Over the past 5 years, the number of active 203(k) loans has increased substantially, from 6,183 at the end of fiscal year 1994 to 43,794 at the end of fiscal year 1998, as figure I.1 shows. The data presented are for all loans still active at the end of each fiscal year, ending September 30 of each year.

Figure I.1: Growth in the Number of Loans Insured Under the 203(k) Program, Fiscal Years 1994-98



Source: GAO's analysis of Federal Housing Administration's (FHA) data.

Table I.1 lists the dollar amount and number of 203(k) loans insured at the end of each fiscal year.

Table I.1: Value and Number of Loans Endorsed in the 203(k) Program, Fiscal Years 1994-98

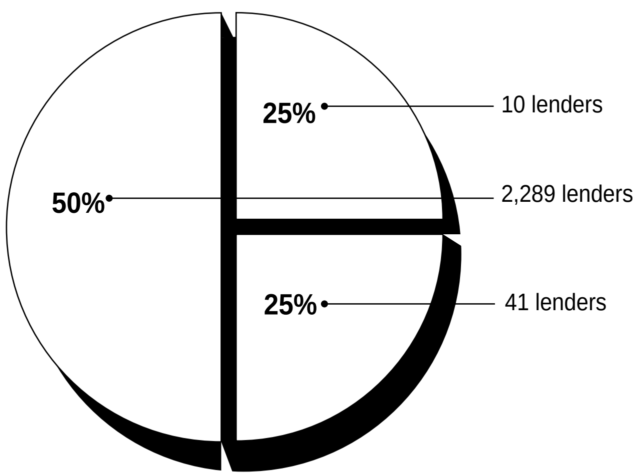
Fiscal year	Value of loans endorsed	Number of loans outstanding
1994	$383,976,630	6,183
1995	652,188,055	9,819
1996	1,478,857,502	19,969
1997	2,471,945,434	31,743
1998	3,592,081,172	43,794

Source: GAO's analysis of Department of Housing and Urban Development (HUD) data.

A Few Lenders Account for Most of the Program's Loans

Since October 1993, 289 of the 2,340 lenders participating in the 203 program have accounted for 80 percent of 203(k) loans, and the top 10 lenders have accounted for 25 percent (15,682 loans). Half of the loans were issued by only 51 lenders. More than half (1,370) of the participating lenders had five or fewer loans. (See fig. I.2.)

Figure I.2: Lenders' Share of 203(k) Loans Endorsed in Fiscal Years 1994-98

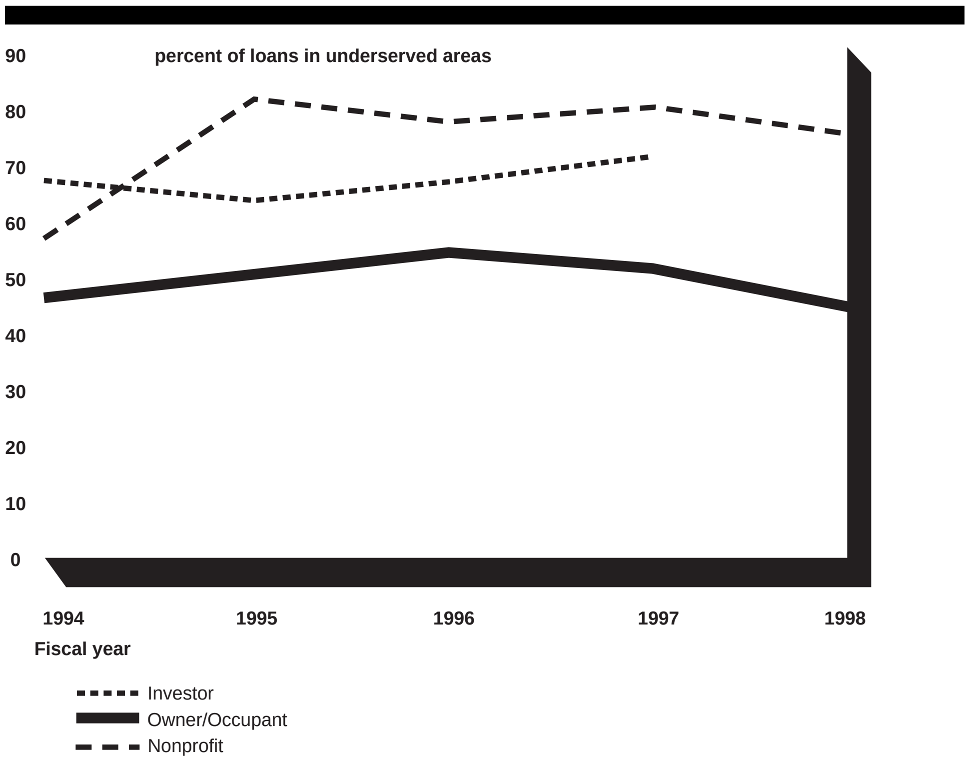


Source: GAO's analysis of HUD's data.

Most 203(k) Loans in Underserved Areas Are Made by Non-Profit Organizations

About 55 percent of all 203(k) loans insured between fiscal years 1994 and 1998 were for properties in underserved areas.[1] By borrower type 75 percent of the loans to nonprofit organizations went to underserved areas, compared with 65 percent of investor loans and 51 percent of owner-occupant loans. These ratios have remained relatively constant over time, as shown in figure I.3.

Figure I.3: Loans Endorsed in Underserved Areas by Borrower Type, Fiscal Years 1994-98



Source: GAO's analysis of data from HUD

[1] Underserved areas are those geographic areas that do not have enough mortgage lenders to meet demand. These areas are usually poor urban areas.

203(k) Application and Rehabilitation Process

When a potential borrower locates an eligible property, the borrower submits an application to a lender and enters into a sales contract that is contingent upon the approval of a 203(k) loan and the borrower's acceptance of any additional required improvements as determined by HUD or the lender. Either the borrower or a consultant describes the work to be done and provides a cost estimate. The rehabilitation must include at least $5,000 of eligible improvements on the existing structure on the property. Eligible improvements include any repair that may affect the health and safety of the occupants. Minor or cosmetic repairs by themselves cannot be included in the first $5,000 but may be added after the $5,000 threshold is reached. Following the lender's acceptance of the proposed work and cost estimate, a written appraisal of the expected market value after rehabilitation work is completed. In some cases, an as-is appraisal is also required.

The lender reviews the application and the appraisal to determine the maximum insurable mortgage amount for the property. The value of the maximum mortgage calculation is based on the lesser of (1) the as-is value of property plus rehabilitation costs or (2) 110 percent of the expected property market value after rehabilitation work is completed. The as-is value of the property is usually based on the borrower's purchase price or, for refinance cases, an as-is appraisal. The rehabilitation cost can include up to six mortgage payments to assist the borrower when the property is not occupied during rehabilitation. The loan is then closed and the lender submits copies of the mortgage documents to HUD for review. If the documents are found acceptable, HUD issues a Mortgage Insurance Certificate to the lender. The borrower then has up to 6 months to complete the rehabilitation work. As the rehabilitation work progresses, funds are released from the rehabilitation escrow account after a HUD-approved inspector reviews the work. Any unused funds in the rehabilitation escrow account are applied to the mortgage.

Scope and Methodology

To assess the risk the program poses to FHA's insurance funds if deficiencies in the program are not corrected, we reviewed several prior reports on the program and obtained data on loan activity from HUD's Single-Family Data Warehouse, which is a database on all 203(k) single family loans and others insured by the FHA, for fiscal years 1994 through 1998. To determine the performance of the program, we obtained data on defaults and claims, types of borrowers, and lenders. To assess the costs of the program, we obtained from HUD's Comptroller's Office data on the total amount of claims paid for the period reviewed and net losses incurred on those claims.

To assess HUD's actions to improve the program, we reviewed reports by HUD management, HUD's Office of Inspector General, and a HUD contractor, which was hired to study the program. We discussed the content of these reports and HUD's plans to address the deficiencies cited in the reports with HUD officials and the contractor.

To determine how HUD oversees the 203(k) program, we reviewed pertinent HUD regulations and policy guidance. We also interviewed officials from HUD's Office of Insured Single-Family Housing and each of the four Homeownership Centers located in Santa Ana, California; Denver, Colorado; Atlanta, Georgia; and Philadelphia, Pennsylvania. To determine the nature and extent of HUD's primary oversight methods, post-endorsement technical reviews and quality assurance reviews, we interviewed cognizant HUD officials and obtained relevant documentation, such as training and policy manuals.

Our reliability assessments of the specific data elements required for this review indicate that the data were reliable enough for our analyses. To assess reliability, we

- reviewed existing information about data quality and controls supporting the data systems,
- performed electronic testing of the data elements used,
- discussed data we analyzed with agency officials to ensure we interpreted the data properly, and
- compared a sample of selected data elements to source documents submitted for endorsement.

During our review we found data indicating several cases in which multiple owner-occupant loans were made to the same borrower. We determined that many of the borrowers with multiple owner-occupant loans were actually investors and nonprofit organizations that were incorrectly coded as owner-occupants in the database.

We performed our work from May 1998 through May 1999 in accordance with generally accepted government auditing standards.

Comments From the Department of Housing and Urban Development

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

May 17, 1999

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Mr. Stanley J. Czerwinski
Associate Director, Housing and Community
Development Issues
United States General Accounting Office
Washington, DC 29548

Dear Mr. Czerwinski:

Thank you for the opportunity to comment on your draft report entitled Homeownership: Problems Persist With HUD's 203(k) Home Rehabilitation Loan Program (GAO/RECD-99-124, Code 385744). Even though the 203(k) program represents just slightly more than 1% of all loans FHA insures (in FY 98, FHA insured approximately 14,130 203(k) loans out of a total of 1.1M insured loans across all programs), FHA believes that the 203(k) program has great potential to help American households, particularly those living in urban areas, to acquire and rehabilitate homes in need of repair. The Department is pleased that the General Accounting Office (GAO) has taken the initiative to evaluate such a minor, yet still important, portion of FHA's overall business.

Prior to identifying specific report recommendations, this response highlights a few areas of the report that are our concern to the Department.

See comment 1.

1. The Department is puzzled by GAO's reliance on the relative claim and default rate between the 203(k) program and FHA's 203(b) program as the primary report measure of overall performance of the 203(k) program. Like all rehabilitation or construction loan programs, the 203(k) program is inherently much riskier than permanent loan programs, such as the 203(b) program. Congress recognized this fundamental difference when it created the 203(k) program by placing it in FHA's General Insurance Fund, a fund that is designed to require ongoing public subsidy to operate. By contrast, Congress placed the 203(b) program in the Mutual Mortgage Insurance fund, a fund that is required by statute to be wholly self sustaining, using no public subsidy to operate. In light of this fundamental difference, it seems strange that GAO experts would look to the 203(b) loan program performance as a comparative basis to the 203(k), rather than investigate the performance of other similar rehabilitation and construction loan programs.

2. The primary conclusion of the GAO report, according to GAO auditor's discussions with FHA officials, is that FHA should more specifically target its lenders monitoring and enforcement actions to 203(k) lenders. Currently, FHA includes 203(k) loans and lenders that originate 203(k) loans in targeting 10% of all insured loans for post endorsement reviews and in targeting lenders for onsite monitoring. Using this system, FHA currently targets the approximately 20% of 203(k) lenders who originate more than 80% of all 203(k) loans for annual reviews. FHA believes this highly targeted approach is a wise use of limited resources.

See comment 2.

3. The GAO report repeatedly refers to increasing monetary losses to FHA resulting from 203(k) loans, but it often fails to distinguish what portion of these losses are simply due to an increase in program volume.

See comment 3.

4. GAO has chose to ignore evidence presented by FHA that refutes statements included in this draft report. In a meeting with senior FHA and GAO officials the Deputy Assistant Secretary for Single Family Housing clearly stated that every Homeownership Center (HOC) has Quality Assurance staff trained in the 203(k) program, and that every HOC targets 203(k) lenders for review. Furthermore, FHA provided GAO evidence indicating that such reviews are being done in all four HOC's.

See comment 4.

5. FHA would like to clarify a statement in the report attributed to senior officials that the current 203(k) program default and claim rates are quote "acceptable". FHA officials have repeatedly stated that the losses associated with the program are to be expected, in light of the fact that the 203(k) program is an acquisition/rehabilitation program which by design is inherently more risky than a permanent loan program. Still, while current rates are within FHA expectations, the Department is also in the midst of reviewing the 203(k) program to determine if some program design changes are in order. For instance, the Department generally agrees with GAO assertion that the 203(k) program as currently designed is overly complicated and unnecessarily bound by rules. The Department's review is ongoing and will likely include some alterations to the program design by the fall of 1999.

See comment 5.

GAO Recommendations and FHA Responses:

Recommendation:

- Improve the Post Endorsement Technical Review process to identify lenders underwriting violations before the program incurs losses as a result of the poor underwriting. Lenders should also be notified immediately of underwriting violations and be required to rectify the violation or risk losing HUD's insurance on the loan.

FHA's Response:

See comment 6.

The Department agrees that lenders with poor underwriting practices as evidenced by unusually high default and claim rates on loans they originate, should be targeted for enforcement actions. However, the Department disagrees with GAO's recommended approach to taking this action. Instead of relying primarily on the post endorsement review process, the Department recently launched a new Credit Watch system, a computerized information management and analysis system that will automatically target 203(k) and other lenders with unusually high loan default and claim rates. Unlike the Mortgagee Review Board and other existing FHA enforcement programs, credit watch is strictly performance based - those lenders with a record of poor performance will either be terminated from FHA programs or they will be placed on Credit Watch, a form of probation that results in heightened scrutiny of lenders' performance. FHA believes this new system will prove to be a highly efficient and effective means of enhancing lender enforcement activities for the 203(k), as well as, all other Single Family programs.

- Recognizing the risk inherent in the program, high-risk 203(k) lenders should be targeted for routine Quality Assurance Reviews to minimize the risks that these lenders pose to the General Insurance Fund.

FHA's Response:

See comment 7.

The Department agrees that high risk, or extremely poorly performing lenders should be targeted for extra monitoring activities. That is why FHA's new Credit Watch system will place poor performing lenders on a form of probation, which consists of a heightened level of review and monitoring on an ongoing basis.

Recommendation:

- Establish strict criteria to ensure that consultants and home inspectors are well versed in residential construction/rehabilitation and cost estimating to protect the interest of the borrowers.

FHA's Response:

FHA agrees that the consultants' role in the 203(k) program needs to be reassessed. As part of the Department review of the entire 203(k) program, GAO's recommendation to require additional training of consultants will be considered.

Recommendation:

- HUD should establish strict criteria for qualifying and re-certifying non-profits for their continued participation in the program to ensure they have the resources and the expertise to rehabilitate properties.

The following are GAO's comments on the Department of Housing and Urban Development's letter dated May 17, 1999.

1. The report clearly indicates that the 203(k) program is inherently more risky than the 203(b) program. We compared the two programs to highlight the inherent risk associated with the 203(k) program and to demonstrate the need to devote resources to oversee the program. Although the 203(k) program is riskier, FHA oversees the two programs in essentially the same way.

2. We disagree that HUD's current monitoring procedures are adequate to minimize the unique risks posed by the 203(k) program. The report reflects information provided by the Homeownership Centers that the 203(k) program is not targeted for review. Since the 203(k) program is much more risky than the 203(b) program, FHA should target lenders' 203(k) activity for oversight. FHA officials were able to provide us with the number of lenders the agency reviewed that had made one or more 203(k) loans. However, they could not tell us the extent to which these lenders' 203(k) activity was reviewed. Furthermore, at the time of our review, none of the Homeownership Centers, which are responsible for overseeing the 203(k) program, targeted lenders for review on the basis of their overall 203(k) loan performance.

3. Since we relied on net loss figures supplied by FHA, we do not provide a detailed explanation of these figures in the report. We do not draw any conclusions from the expected increase in net losses other than that FHA expects the program to incur increasing net losses from the time period covered by our review. We point to other factors, such as an increase in the early default rate, as an indication that the quality of loans made under the program may be getting worse. We also state that the net losses as a percentage of endorsements are in contrast to the net gains as a percentage of endorsements expected for the 203(b) program over the same time period. We use this fact as a further illustration that the 203(k) program is riskier than the 203(b) program and that FHA should oversee it differently. The report does note that the program experienced substantial growth during the period covered by our review.

4. We disagree. FHA did not provide GAO evidence that its staff have been trained in conducting 203(k) reviews. Our report reflects the additional information provided by the Deputy Assistant Secretary for Single-Family Housing regarding the targeting of 203(k) lenders for review. In the report we include FHA's information showing that the four Homeownership

Centers performed 52 quality assurance reviews on lenders that made 203(k) loans. However, the information provided does not show how many 203(k) loans have been reviewed. In addition, the information provided by FHA did not show that every Homeownership Center has quality assurance staff trained in the 203(k) program. Finally, during our review, officials at two Homeownership Centers told us that they did not have staff qualified to do quality assurance reviews.

5. HUD clarified its statement that the 203(k) program default and claim rates are acceptable. HUD noted that while the losses are to be expected, it is reviewing the program to determine if some program design changes are needed. We have incorporated these clarifications where appropriate. In addition, while our report states that the 203(k) program is complex because of the rehabilitation component of the program, we did not state that the program is unnecessarily bound by rules.

6. We do not agree that the Credit Watch system will improve the post-endorsement technical review process, which identifies underwriting violations early in the life of the loans to mitigate potential losses before they occur. HUD announced the Credit Watch program on May 12, 1999. This program is designed to identify high-risk lenders with high default and claim rates. As we note in our report, a post-endorsement technical review is intended to identify loan underwriting violations or weaknesses before losses have occurred. Credit Watch is not designed to improve the process for identifying and notifying lenders of violations discovered in the post-endorsement technical review. The intent of our recommendation is to promptly resolve deficiencies noted in the reviews in an attempt to prevent or mitigate losses before they occur. We recognize that the Credit Watch program may be an effective tool to identify problem lenders.

7. The Credit Watch program is designed to identify lenders with high default and claim rates. It does not, however, identify lenders based on specific program loan activity. In most cases, the lenders' portfolio of 203(k) loans is a small percentage of their overall portfolio of FHA loans. Consequently, problems with a lender's 203(k) portfolio would not be noticed unless they were encountering high default and claim rates with their non-203(k) loans. The intent of our recommendation is to target high-risk lenders on the basis of their experience with 203(k) loans, which are inherently more risky than many other types of FHA-insured loans. If the Credit Watch program is modified to identify high-risk lenders by the various FHA programs, HUD may be able to capture lenders' performance in the programs identified as high risk.

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