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Report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate

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MULTIFAMILY HOUSING

Improvements Needed in HUD's Oversight of Lenders That Underwrite FHA-Insured Loans

GAO

Accountability * Integrity * Reliability

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Abbreviations

FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
MAP	Multifamily Accelerated Processing

United States General Accounting Office
Washington, DC 20548

July 19, 2002

The Honorable Susan M. Collins
Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate

Dear Senator Collins:

Each year, the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) insures billions of dollars in multifamily housing mortgage loans to facilitate the construction, substantial rehabilitation, purchase, and refinancing of apartments and health care facilities. FHA mortgage insurance protects lenders against financial losses stemming from a borrower's default. When default occurs, a lender may elect to assign the mortgage to HUD and file an insurance claim with HUD for the unpaid principal balance of the loan. As of September 30, 2001, FHA had approximately 15,000 multifamily mortgages in its insured portfolio, with a total unpaid principal balance of about $55 billion. In May 2000, HUD implemented a program called Multifamily Accelerated Processing (MAP) to expedite and standardize the insurance application process for its most frequently used multifamily loan programs. Similar to HUD's Direct Endorsement program for single-family housing lenders, a key feature of the MAP program is its delegation of significant responsibilities to multifamily housing lenders for underwriting the loans that FHA insures. To mitigate its financial risks, HUD developed controls and procedures designed to ensure that lenders participating in the MAP program are qualified and are complying with FHA's underwriting standards. HUD's Office of Multifamily Housing and multifamily housing field offices are responsible for implementing these controls and procedures.

In April 2000, we reported on weaknesses in HUD's oversight of single-family lenders participating in the Direct Endorsement program.[1] Concerned that similar problems might exist with multifamily lenders, you

[1]U.S. General Accounting Office, *Single-Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk*, GAO/RCED-00-112 (Washington, D.C.: Apr. 28, 2000).

asked us to provide information on HUD's oversight of lenders participating in the MAP program. Accordingly, our report addresses the following questions: (1) How well does HUD ensure that lenders participating in the MAP program meet HUD's qualification requirements? (2) How well is HUD implementing its processes for reviewing and monitoring MAP lenders' underwriting of loans? (3) Has HUD held any MAP lenders accountable for noncompliance with program requirements? To address these questions, we reviewed the activities of HUD's Office of Multifamily Housing and 8 of its 51 multifamily field offices in Baltimore, Maryland; Chicago, Illinois; Cleveland, Ohio; Denver, Colorado; Fort Worth, Texas; Phoenix, Arizona; San Antonio, Texas; and San Francisco, California. Our work focused on the 35 new construction and substantial rehabilitation loans insured under the MAP program by these 8 offices between May 2000 and August 2001, and the 20 lenders that made these loans. The 35 loans had a total value of approximately $500 million, or about 75 percent of the value of all new construction and substantial rehabilitation loans insured under the MAP program during that period. The 20 lenders accounted for about half of those that made MAP loans during that timeframe. Appendix II provides detailed information on our objectives, scope, and methodology.

Results in Brief

HUD lacks assurance that the lenders approved to participate in the MAP program always met all of HUD's qualification requirements. HUD's guidance requires prospective MAP lenders to submit documents showing that the lender is financially sound, has a satisfactory lending record, and has qualified underwriters. HUD uses this documentation, which includes audited financial statements and staff's resumes, as its primary basis for approving or rejecting a lender. Our review of HUD's approval files for 20 MAP lenders found that HUD followed its procedures in determining that these lenders met requirements for financial soundness and satisfactory lending. However, we also found that HUD did not always have a sufficient basis for determining that the lenders' underwriters met qualification standards. For example, the resumes for 22 of the lenders' 81 underwriters did not provide clear evidence that these individuals had at least 3 years of recent multifamily underwriting experience, as required by HUD's guidance. Finally, in approving MAP lenders, HUD did not determine whether the lenders had required quality control plans, an internal control mechanism designed to ensure compliance with HUD's underwriting requirements. In large part, these problems occurred because of HUD's insufficient guidance to its own staff and to MAP lenders.

HUD did not always comply with or effectively implement controls and procedures for reviewing and monitoring MAP lenders' underwriting of loans. HUD's procedures require field staff, prior to insuring a loan, to conduct and document reviews of lenders' mortgage insurance applications and associated loan exhibits to ensure lenders' compliance with HUD underwriting requirements. However, at the field offices we visited, we found that the staff did not always properly document their reviews. For example, we found that the staff did not prepare one or more of the required review documents for 28 of the 35 loans we examined. Furthermore, the field offices did not always ensure that lenders were adhering to HUD's underwriting requirements, including those for property appraisals. Among other things, the appraisal is to include estimates of the income and operating expenses of the property being insured. For 9 of the loans we found that the operating expenses for the insured properties were understated by 5 to 9 percent, because the field office did not enforce HUD's requirement to update the expense estimates to the date of the appraisal. The field offices attributed these problems, among other things, to unclear guidance and to the field offices' heavy workloads. HUD also instituted a process to monitor MAP lenders' underwriting of loans through quality assurance reviews of loans already approved for mortgage insurance. However, as of March 2002—almost 2 years after the MAP program's inception—HUD had not fully staffed the division responsible for this function. As a result, the division conducted 24 reviews in fiscal year 2001, which, according to the division director, is only about one-third the number that a fully staffed division could have performed. In addition, the division has not developed written operating procedures or a systematic process for analyzing the results of its reviews.

HUD has held some MAP lenders accountable for specific violations of program requirements but has had a limited basis for identifying any lenders that might exhibit patterns of noncompliance. To hold lenders accountable for specific violations or for patterns of noncompliance, HUD's Office of Multifamily Housing can suspend or terminate their ability to participate in the MAP program. As of March 2002, Multifamily Housing had suspended three MAP lenders for specific violations. In contrast, it had not sanctioned any lenders for exhibiting patterns of noncompliance, because weaknesses in its quality assurance process and the newness of the MAP program provided a limited basis for identifying such patterns.

This report makes recommendations to the Secretary of HUD designed to improve HUD's processes for approving lenders to participate in the MAP program and for reviewing and monitoring these lenders' underwriting of FHA-insured loans. HUD agreed with each of our recommendations.

Background

Established by the National Housing Act, FHA administers several programs that support multifamily housing for low- and moderate-income families by insuring loans made by private lenders. Specifically, these programs insure mortgage loans for the construction, purchase, substantial rehabilitation, and refinancing of multifamily apartments and health care facilities. FHA insures most of its mortgages for multifamily housing under its General Insurance Fund and Special Risk Insurance Fund. To cover lenders' losses, FHA collects insurance premiums that borrowers pay to the lenders and deposits the premiums into the funds. In addition, because the funds were not designed to be self sustaining, Congress provides budget authority as part of FHA's budget each fiscal year to cover anticipated costs—known as "credit subsidy costs"—for some of the multifamily insurance programs.[2] In fiscal year 2001, Congress provided $101 million in credit subsidy budget authority to FHA.

When a default occurs on an insured loan, the lender may elect to assign the mortgage to HUD—effectively making the Department the new lender for the mortgage[3]—and file an insurance claim with HUD for the unpaid principal balance of the loan.[4] As a result, the lender is protected from financial losses stemming from a borrower's default. FHA's multifamily insurance programs also benefit borrowers by providing favorable financing terms. For example, under one of the programs, nonprofit borrowers can finance up to 100 percent of a project's replacement costs, and for-profit borrowers can finance up to 90 percent of these costs. As of September 30, 2001, FHA had about 15,000 multifamily mortgages in its insured portfolio, with a total unpaid principal balance of approximately $55 billion.

[2]The credit subsidy cost is the net present value of the estimated long-term costs to the federal government of extending or guaranteeing credit, calculated over the life of the loan and excluding administrative costs. Budget authority is the authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal funds. HUD's process for estimating credit subsidy costs is discussed in U.S. General Accounting Office, *Multifamily Housing Finance: Funding FHA's Subsidized Credit Programs*, GAO-02-323R (Washington, D.C.: Feb. 1, 2002).

[3]HUD's policy is to attempt to restore the financial soundness of the mortgage through a workout plan. If a workout plan is not feasible, HUD may, as a last resort, foreclose on the mortgage.

[4]The actual claim payment may reflect dollar amounts added to or subtracted from the unpaid principal balance of the loan. For example, any mortgage insurance premiums the lender paid to HUD after the date of loan default are added to the unpaid principal balance.

To obtain an FHA-insured loan, a prospective borrower must use a lender approved by HUD's Lender Approval and Recertification Division, and the HUD-approved lender, in turn, must submit a mortgage insurance application to HUD. HUD's multifamily housing field offices—comprising 18 "hubs" and their associated 33 program centers—are responsible for processing the applications and approving or rejecting them. Historically, these responsibilities included the bulk of the loan underwriting duties, such as preparation of the property appraisal, mortgage credit analysis, and other loan exhibits. Because this process was often slow and inefficient, in 1994 HUD developed an expedited approach for processing loan insurance applications—known as "fast-track"—that delegated certain underwriting functions to the lenders. About 30 of HUD's field offices eventually adopted fast-track processing, but, according to HUD, variations existed among the offices regarding the extent of the functions delegated to the lenders and the thoroughness of the offices' review of loan documents.

In order to standardize the responsibilities of both lenders and the field offices, in May 2000, HUD implemented the Multifamily Accelerated Processing (MAP) program for several of its insurance programs, including the most widely used programs.[5] HUD's objective for the MAP program was to provide a consistent, reliable, and expedited process that would enable FHA to insure more loans while limiting risk to the FHA insurance funds. To accomplish this objective, HUD, among other things, developed a new guidebook for lenders and HUD staff and established set time frames for the mortgage insurance application and review process. In addition, although HUD delegated significant underwriting responsibilities to the lenders, it continued to retain the final underwriting decision authority. Under MAP, a lender's insurance application goes through a two-stage review process.[6] The first stage, called "pre-application," focuses on the overall eligibility and feasibility of the property to be insured (for

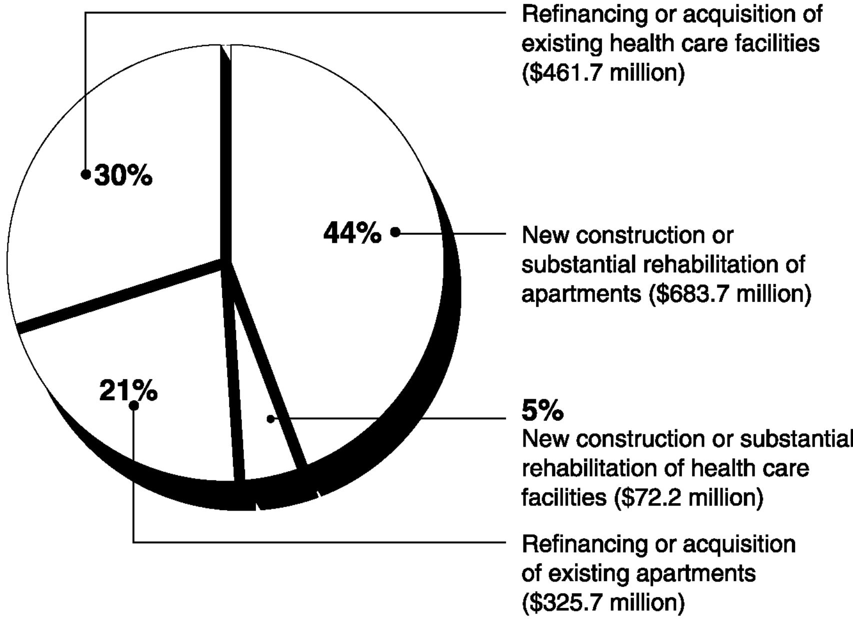
[5]The programs included under MAP are Section 220 (construction or rehabilitation of rental housing for urban renewal and concentrated development areas), Section 221(d)(3) (construction or substantial rehabilitation of rental and cooperative housing with nonprofit or cooperative borrowers), Section 221(d)(4) (construction or substantial rehabilitation of rental and cooperative housing with for-profit borrowers), Section 223(f) (refinancing or acquisition of existing rental housing), Section 232 (construction or substantial rehabilitation of nursing homes, intermediate care, board and care, and assisted-living facilities), and Section 232/223(f) (refinancing or acquisition of existing nursing homes, intermediate care, board and care, and assisted living facilities).

[6]Insurance applications for refinancing and acquisition loans start at the firm commitment stage.

example, whether a sufficient market exists for the property). If an application passes this stage, HUD invites the lender to submit a complete set of underwriting exhibits as part of the second stage, known as “firm commitment.” If the application passes this stage and the borrower agrees to accept the conditions of the FHA mortgage insurance agreement, the loan becomes FHA-insured.

Although only about 30 percent of all multifamily loans insured by FHA in fiscal year 2001 were insured through the MAP program, HUD expects that in subsequent years the large majority of its insured multifamily loans will be MAP loans. During fiscal year 2001, HUD insured 212 loans under the MAP program, with a total value of about $1.5 billion. As shown in figure 1, this total was about equally divided between new construction and substantial rehabilitation loans and refinancing and acquisition loans.

Figure 1: Value of MAP Loans Insured during Fiscal Year 2001, by Loan Type



Source: GAO's analysis of data from HUD.

To mitigate the financial risks of the MAP program, HUD established controls and procedures covering the (1) approval of MAP lenders, (2) review and monitoring of lenders' underwriting of loans, and (3) sanctioning of poorly performing lenders. Specifically:

- HUD requires HUD-approved lenders wanting to participate in the MAP program to apply to the Lender Qualifications and Monitoring Division within HUD's Office of Multifamily Housing. The division is responsible for reviewing documentation submitted by the lender and deciding whether or not the lender meets the MAP program's qualification standards. In addition, for every mortgage insurance application submitted by a MAP lender, the cognizant HUD multifamily field office is required to review the qualifications of the lender's staff involved in making the loan. As of March 2002, HUD had approved about 100 lenders to participate in the MAP program.
- HUD's multifamily field offices are responsible for conducting and documenting reviews of MAP mortgage insurance applications and associated loan exhibits (for example, appraisal, market study) to ensure lenders' compliance with HUD's underwriting requirements. At both stages of the application process, a team of technical specialists, known as a MAP

team, with expertise in the areas of architecture, property appraisal, mortgage credit, and building costs reviews the application and its associated underwriting exhibits. The MAP team may require the lender to correct underwriting deficiencies uncovered by the reviews. After each stage of review, the team's supervisor, called the MAP team leader, is required to provide a recommendation to the field office director on whether to accept or reject the application. On the basis of the team leader's recommendation, the field office director decides whether or not to insure the loan. The field offices are to complete each stage of their reviews within 45 to 60 days, depending on the type of loan. To further monitor MAP lenders' underwriting of loans and to oversee the work of the field offices, teams of field staff assigned to HUD's Lender Qualifications and Monitoring Division are to conduct comprehensive reviews of samples of loans already approved for mortgage insurance. These reviews focus on the same four technical areas that the field offices analyze in reviewing an insurance application. After completing a review, the teams are to document their findings and recommendations in written reports, which are to be reviewed and approved by the division's director. Upon approval, the reports are issued to the cognizant lender and multifamily field office.

- If HUD determines that a lender is not complying with program requirements, HUD's Office of Multifamily Housing may take enforcement actions against the lender. Specifically, Multifamily Housing has the authority to suspend or terminate a lender's participation in the MAP program.

HUD Had Reasonable Assurance That MAP Lenders Met Requirements for Financial Soundness and Lending Performance, but Not for Qualified Underwriters

HUD's guidance requires an FHA-approved lender wishing to participate in MAP to submit documentation demonstrating, among other things, that it is financially sound, has a satisfactory lending record, and has qualified underwriters. Our review of HUD's approval files for 20 MAP lenders found that HUD followed its procedures in determining that these lenders met the requirements for financial soundness and satisfactory lending. However, we also found that HUD sometimes lacked a sufficient basis for determining whether the lenders' underwriters met MAP qualification requirements. Furthermore, in approving MAP lenders, HUD did not ensure that the lenders had quality control plans in accordance with HUD's regulations.

Lenders Met Qualifications for Financial Soundness and Lending Performance

According to HUD's guidance, a lender must, among other things, be financially sound and have a satisfactory lending record to qualify for the MAP program. As evidence of its financial soundness, a prospective MAP lender must provide HUD with a recent audited financial statement showing a net worth in excess of $250,000. As evidence of a satisfactory lending record, a lender must submit information on the FHA-insured and conventional multifamily housing loans it made during the previous 5 years. For the lender's FHA-insured loans, the submission must include a list of the loans that were assigned to HUD for insurance benefits and a narrative explanation of why the assignments occurred. HUD uses this information to (1) determine whether the lender has a recent history of assignments that can be attributed to poor lending practices and (2) ask cognizant multifamily field offices about their experience with the lender.

To determine whether approved MAP lenders met HUD's requirements, we examined HUD's approval files for the 20 lenders that made the 35 new construction and substantial rehabilitation loans we reviewed during our visits to eight of HUD's multifamily field offices. We found that all 20 lenders provided the required documentation and that the documentation adequately supported HUD's conclusion that the lenders met the criteria for financial soundness and satisfactory lending records. Specifically, we found that 19 of the 20 lenders we reviewed submitted the required audited financial statements and that the statements showed the lenders met the net worth requirement. In accordance with HUD's guidance, the remaining lender was exempted from the requirement because its accounts were insured by the Federal Deposit Insurance Corporation.[7] With respect to lending performance, we used a HUD database containing assignment information to confirm that all 20 lenders submitted complete lists of their assigned loans. The lenders either had no loans assigned to HUD or had few assignments relative to their total number of FHA-insured loans—an indicator of sound lending practices, according to HUD. In addition, we reviewed the responses from HUD's field offices about each lender's performance and found that the overwhelming majority of the responses supported approval of the 20 lenders.

[7]HUD does not require certain lenders, known as "supervised" lenders, to submit financial statements. A supervised lender is a financial institution that is a member of the Federal Reserve System or an institution whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration.

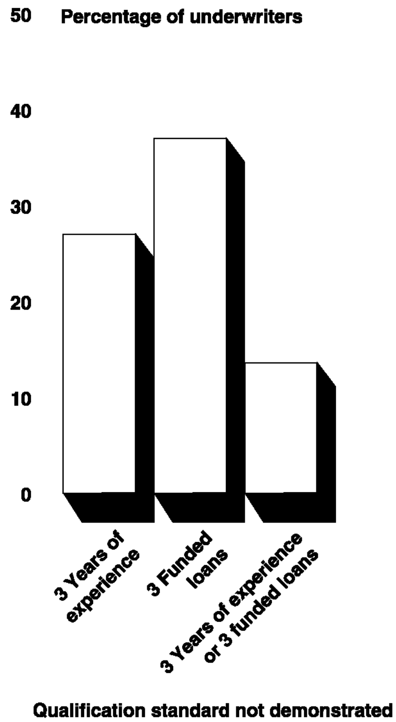
HUD Lacked Assurance That Lenders' Underwriters Were Qualified

Although HUD retains the authority for the final underwriting decision for MAP loans, it relies heavily on the lenders' underwriters to ensure that the loans pose a reasonable financial risk. The underwriter is an employee of the lender, who is responsible for ensuring compliance with applicable requirements and for approving or rejecting a loan on the basis of a review and analysis of the loan exhibits. HUD's guidance sets forth experience and training requirements for underwriters and requires a prospective MAP lender to submit the resumes of those underwriters who will have responsibility for MAP loans. According to HUD's guidance, the resumes must demonstrate that these individuals have at least 3 years of recent experience in underwriting multifamily housing loans and have underwritten at least three loans that were funded. In evaluating a prospective MAP lender, the Lender Qualifications and Monitoring Division within HUD's Office of Multifamily Housing is required to review the resumes and approve those underwriters who meet the requirements. In addition, HUD's multifamily field offices may subsequently approve additional underwriters who are qualified.

Lenders frequently have more than one individual who is authorized to underwrite loans. Thus, HUD approved a total of 81 underwriters for the 20 lenders we reviewed.[8] We found, however, that HUD sometimes approved underwriters without having a sufficient basis for determining whether the underwriters met the qualification requirements of the MAP program. Specifically, the resumes for 22 of the 81 underwriters did not provide clear evidence of at least 3 years of recent underwriting experience; and the resumes for 30 did not provide evidence of 3 funded loans. Furthermore, 11 of the resumes did not provide clear evidence that either requirement had been met. (See fig. 2.)

[8]Seventy-three of the underwriters were approved by the Office of Multifamily Housing, while the remaining eight were approved by the multifamily field offices.

Figure 2: Percentage of Underwriters Whose Resumes Did Not Demonstrate that They Met Qualifications for the MAP Program



Source: GAO's analysis of resumes for 81 MAP underwriters approved by HUD.

In some cases, the resumes showed some underwriting experience but less than 3 years of experience. In other cases, the resumes cited experience only in loan administration, processing, or origination—activities that can encompass a range of duties that may or may not involve significant underwriting responsibilities. Although some HUD officials told us that they knew from first-hand knowledge that the underwriters met HUD's experience standards, others indicated that they were not aware of the standards, had applied the standards loosely, or had drawn inferences about the underwriters' qualifications without knowing whether these inferences were accurate. By not applying the qualifications standards in a strict and consistent manner, HUD increases its chances of insuring loans underwritten by individuals who lack sufficient expertise in evaluating financial risk.

HUD's guidance states that in addition to having proper experience, an underwriter must attend a MAP training session before submitting a mortgage insurance application to HUD. The main objective of the training is to familiarize the underwriter with the MAP process and the roles and responsibilities of both the lender and HUD under this process. HUD's multifamily field offices are responsible for ensuring that the underwriters who submit insurance applications have met the training requirement. During our visits to HUD's multifamily field offices, we reviewed 35 loans submitted by 22 separate underwriters. Our review of HUD's training records indicated that only 10 of the 22 underwriters attended MAP training. Without proper assurance that underwriters are trained, HUD increases the likelihood that MAP underwriters will not be familiar with the program's requirements and will make errors that increase HUD's review time and insurance risk. Field office officials acknowledged that they did not always verify whether underwriters had attended MAP training, citing incomplete local training records and the absence of a nationwide list of trained underwriters as factors that made this verification difficult. To help address this problem, the Lender Qualifications and Monitoring Division in January 2002 developed a nationwide list of trained underwriters. In addition, the division director told us that better attendance records would be kept at future MAP training sessions.

HUD inconsistently applied its qualifications standards for the underwriters we reviewed largely because of a lack of clear guidance. For example, HUD's guidance for approving underwriters does not clearly define the meaning of "underwriting experience." As a result, the HUD officials responsible for approving the underwriters interpreted the guidance differently. One official, for example, said that work in "loan origination" counted as underwriting experience; another official said it did not, because loan origination focuses on the marketing of loans. Similarly, another official told us that he counted property appraising as underwriting experience; another did not. In addition, although HUD's guidance authorizes the multifamily field offices to approve MAP underwriters, that portion of the guidance does not cite the specific requirements of 3 years of experience and three funded loans. Accordingly, staff at four of the eight field offices we visited told us they were not aware of these standards.

HUD Did Not Require Quality Control Plans as a Condition of MAP Approval

According to HUD's regulations, all FHA-approved lenders must implement a written quality control plan. A quality control plan is an important internal control mechanism because it sets forth a program of independent review designed, among other things, to ensure compliance with HUD's requirements and to prompt corrective actions when deficiencies are found. For example, a quality control plan may require a lender to have a certain percentage of its loans reviewed either by external auditors or by individuals on the lender's staff who are independent of the loan processing and underwriting functions.

Although HUD has implemented specific written standards for single-family housing lenders' quality control plans, it has not done so for lenders that make multifamily housing loans. According to the Director of HUD's Lender Approval and Recertification Division—the office responsible for granting lenders HUD-approved status—establishing the standards had not been a high priority because, until the MAP program was implemented, HUD retained primary responsibility for underwriting the multifamily loans insured by FHA. He said that because of the lack of standards, most lenders applying for HUD approval did not submit quality control plans for their multifamily lending operations. Accordingly, in our examination of the division's files we found a multifamily quality control plan for 1 of the 20 lenders we reviewed.

Multifamily Housing officials told us that their decision not to require a quality control plan as a condition of MAP approval was influenced by several factors, including (1) the Department's lack of standards for these plans, (2) the difficulty of developing standards that would be suitable for both large and small lenders, and (3) concerns that lenders would treat the plans as merely a paperwork requirement. In our view, however, the MAP program's delegation of greater underwriting responsibilities to lenders heightens the need for lenders to implement quality control measures. Furthermore, these problems could be overcome through consultation with large and small lenders in developing quality control standards, and through the Department's enforcement of these standards.

Processes and Procedures for Reviewing and Monitoring MAP Lenders' Underwriting of Loans Were Not Always Effectively Implemented

HUD did not always comply with or effectively implement processes and procedures for reviewing and monitoring MAP lenders' underwriting of loans. HUD's procedures require field staff to conduct and document reviews of lenders' mortgage insurance applications to ensure lenders' compliance with HUD's underwriting requirements before the loans are insured. However, at the field offices we visited, we found that the staff did not always properly document their reviews. Furthermore, the field offices did not consistently ensure that lenders were adhering to HUD requirements for property appraisals, a critical element of the loan underwriting process. To some extent, the offices attributed these problems to their heavy workloads. In addition to the field offices' reviews, HUD has established a quality assurance process to review samples of loans after they have been approved for insurance. However, HUD has not fully staffed the division responsible for this function. Consequently, the division conducted significantly fewer reviews than it could have done if it had been fully staffed, according to the division director. In addition, the division has not developed written operating procedures or a systematic process for analyzing the results of its reviews.

Field Offices Did Not Properly Document Reviews

HUD's guidance requires the multifamily field offices to perform reviews of mortgage insurance applications and associated loan exhibits at both the pre-application and firm commitment stages of the application process. In conducting these reviews, a team of technical specialists, known as a MAP team, is required to use standardized checklists that delineate the specific areas the review should cover. The checklists are designed to document the specialists' thorough review of the application, approval or rejection of the application, and recommendations to place conditions on the approval, if necessary. After each stage of review, the team's supervisor, called the MAP team leader, is required to prepare a memo to the field office's director that summarizes the results of the technical reviews and provides a recommendation to accept or reject the application. The memo should also indicate whether the team leader rejected or modified the recommendation of a technical reviewer. However, we found that field staff did not always prepare these checklists and memos as required.

At the eight field offices we visited, we reviewed HUD's records for 35 new construction and substantial rehabilitation loans insured between May 2000 and August 2001 to determine the field offices' compliance with MAP review procedures. We found that the field staff did not prepare one or more of the required review documents for 28 of the 35 loans we examined. Specifically, 12 of the cases were missing one or more of the technical specialists' checklists, and 25 cases were missing one or more team leader memos. (See table 1.) Furthermore, even when the checklists were used, they were not always signed by the reviewer or did not clearly indicate approval or rejection of the application. Quality assurance reviews by the Office of Multifamily Housing's Lender Qualifications and Monitoring Division have found similar problems with the field offices' documentation of reviews.

Some field office staff told us these problems were attributable in some cases to their lack of familiarity with the MAP program's documentation requirements during the early stages of program implementation. However, other staff said they did not have time to document their reviews or did not think that use of the checklists and memos was mandatory. Without proper documentation, however, HUD lacks adequate assurance that technical staff are performing thorough reviews and that team leaders' recommendations to approve insurance applications are properly supported.

Table 1: Number of Loans Missing Required Review Documents

Required review document	Cases missing one or more documents	Cases with all documents on file	Total cases
Technical review checklists	12	23	**35**
Team leader memos	25	10	**35**

Source: GAO's review of HUD's documents for 35 MAP loans.

Field Offices Did Not Always Ensure Lenders' Compliance with HUD's Requirements

In conducting their reviews of MAP insurance applications, field staff are expected to determine whether the lender complied with specific underwriting requirements set forth in HUD's guidance. To determine the extent to which the field offices ensured lenders' compliance, we focused on HUD's requirements for property appraisals, a critical component of loan underwriting. Among other things, HUD's guidance indicates that an appraisal should (1) use rent and expense information from at least three comparable properties as a basis for estimating the expected rental income and operating expenses of the subject property; (2) update the operating expense estimate for the subject property to the date of the appraisal; (3) account for comparable properties' occupancy rates and rent concessions—factors that affect rental income—in estimating income for the subject property; and (4) be no more than 120 days old at the time the mortgage insurance application reaches the firm commitment stage. Despite this guidance, however, for the 35 loans we reviewed, we found that the field offices did not always ensure lenders' compliance with these requirements. The Lender Qualifications and Monitoring Division has also found problems with appraisals, as well as deficiencies in other aspects of the loan underwriting.

Among other things, the appraisal estimates the income (generated primarily from rents) and operating expenses of the property being insured, or "subject" property. As a basis for these estimates, the appraiser uses rent and expense data from existing properties—known as comparable properties—that are as similar as possible to the subject property in size, location, age, and other characteristics. Because no two properties are identical, the appraiser must make adjustments to these rent and expense data to account for differences between the comparable properties and the subject property, and must use the adjusted data as a basis for making estimates regarding the subject property. These estimates are important because a property's net income (that is, gross income minus expenses) is a major factor in determining the size of the mortgage the property can support and HUD will insure. In general, the higher a property's net income, the larger the mortgage it can qualify for.

In accordance with HUD's guidance, we found that the appraisals for all 35 loans provided rent and expense data from at least three comparable properties as a basis for estimating the subject property's rental income and operating expenses. In addition, we found that the rent data in the appraisal were consistent with other data sources,[9] and that these data supported the rental income estimate for the subject property. However, the same did not always hold true for the expense data and operating expense estimates. To corroborate the appraisal's expense data for the comparable properties, we used HUD's Financial Assessment Subsystem—–a database containing audited financial statements for all HUD-insured and –assisted properties.[10] The appraisals for 10 of the 35 loans we reviewed used one or more comparable properties that were HUD-insured or –assisted and for which corresponding expense

[9]We corroborated the rents for the comparable properties by checking apartment rental guides and Web sites and by contacting apartment leasing offices.

[10]According to HUD officials, expense data for non-HUD properties are not readily available because property owners consider the data to be proprietary business information.

information was available in HUD's database.[11] In 9 of the 10 cases, we found that the appraisals cited lower expenses for the comparable properties than did the corresponding information in the database.[12] The appraisals' understatement of expenses for the comparable properties ranged from about $28,000 to $270,000 per year. This situation is problematic because an underestimation of expenses can lead to an overestimation of net income and approval of a higher mortgage amount than the property can support. The field office staff who reviewed the appraisals told us that they had not been aware of these discrepancies for most of the properties and, in any event, felt that the operating expense estimates for the subject properties were reasonable based on their experience and knowledge as professional appraisers. However, they also acknowledged that appraisers sometimes made estimates that were not well supported by expense data from comparable properties, as required, and that this practice raised questions about the quality of the appraisals. Some field office staff said they did not try to corroborate the expense data for the comparable properties against information in HUD's database because this was not a required part of their review and they did not have time to do it. Similarly, Office of Multifamily Housing officials told us that the field offices should not be performing this task because to do so would overstep HUD's role in relation to the lenders under the MAP program. However, given that HUD, and not the lender, bears the financial risk of a MAP loan, HUD should take reasonable steps to protect its financial interests. Given the importance of the subject property's estimated operating expenses in determining the mortgage amount that HUD insures, HUD would be prudent to use data in its Financial Assessment Subsystem to help ensure that the estimate is based on accurate information.

According to HUD's guidance, the operating expense estimate for the subject property should be updated by the lender to the date of the appraisal. The updating procedure involves the application of an inflation rate to account for the age of the data used to develop the expense estimate. For example, if the data are current as of January 1, 1999 (known as the data's "effective date"), and the appraisal is conducted in January 1,

[11]The appraisals for two other loans used HUD-insured nursing homes as comparable properties. However, according to Multifamily Housing officials, expenses for nursing homes and other health care facilities are accounted for differently in appraisal reports than they are in the financial statements in HUD's database. As a result, the expense data from these two sources are not comparable.

[12]In the remaining case, the expenses cited in the appraisal were higher than those reflected in the database.

2001, the expense estimate should be adjusted upward to reflect 2 years of inflation. However, for 27 of the 35 loans we reviewed, we found that the lender did not properly update the expense estimate, and the field office did not require the lender to correct the error. As a result, the operating expense estimates for 9 of these loans were 5 to 9 percent lower than if the updating procedure had been done correctly.[13] When a property's actual operating expenses are higher than originally estimated, its ability to support the mortgage may be weakened, thereby increasing HUD's insurance risk. Some field staff told us they did not see a need to correct the errors or inform the lenders of these problems because they felt the magnitude of the understatement was too small to significantly affect HUD's risk. However, Office of Multifamily Housing officials told us that the operating expenses should always be updated. We also found that some field staff were unclear on how to perform the updating procedure because the instructions in MAP program guidance were vague. The instructions for the updating procedure are located in both a standard HUD appraisal form and in MAP program guidance. However, unlike the form's instructions, the MAP guidance does not indicate that the effective date of the expense data is the beginning date of the fiscal year in which the expenses were accrued.[14] When the effective date used is not the beginning date of the fiscal year, the time period for which the data are updated is shortened, resulting in an understatement of the expense estimate for the subject property.

HUD's guidance also requires that the appraisal account for the comparable properties' occupancy rates and rent concessions in estimating income for the subject property. Specifically, if the occupancy rate for the comparable property is lower than the occupancy rate estimated for the subject property, the guidance requires that a downward adjustment be made to the comparable property's rent to reflect this difference. Similarly, if a comparable property is offering rent concessions (for example, first month's rent free), the rent should again be adjusted downward. When these downward adjustments are not made, the rental income for the subject property can be overestimated, which, in turn, can lead to an overestimation of the property's net income. Despite HUD's guidance, however, we found that the appraisals for 11 of the 35 loans did

[13]For the remaining 18 loans, the estimates were understated by less than 5 percent.

[14]For example, for expenses accrued during a fiscal year running from May 1, 2000, through April 30, 2001, the effective date of the corresponding expense data would be the beginning date of that fiscal year, or May 1, 2000.

not make adjustments to account for lower occupancy rates at the comparable properties. Furthermore, in 5 cases, no adjustments were made for rent concessions at the comparable properties, even though these concessions were mentioned in the appraisal reports. Although the adjustments in these cases would have been minor and would not have affected the properties' net income, HUD's guidance does not make exceptions for such situations. Moreover, none of this noncompliance was documented in the field office's reviews of the appraisals. Field office staff told us they generally did not bother documenting instances of minor noncompliance or notifying the lender of such problems because (1) doing so would make it more difficult for them to stay within the required review time frames and (2) according to HUD's guidance, their role as reviewers is to require lenders to correct only those underwriting deficiencies that significantly affect HUD's insurance risk.

Finally, HUD guidance states that an appraisal should be no more than 120 days old at the time the lender's insurance application reaches the firm commitment stage of HUD's review. When an appraisal is beyond the 120-day point, the guidance permits the lender to update the appraisal in lieu of doing a new one. According to Office of Multifamily Housing officials, the purpose of this requirement is to ensure that the appraisal's conclusions reflect current market conditions. However, for 7 of the 35 loans we reviewed, the age of the appraisals exceeded 120 days and no update was submitted. Specifically, the 7 appraisals ranged from 121 to 251 days old at the firm commitment stage. HUD field office officials told us that they accepted the appraisals without an update because, to their knowledge, market conditions had not changed since the time the appraisal was originally performed.

The Lender Qualifications and Monitoring Division has found similar appraisal deficiencies that were not identified during the field office's review. These problems included situations where operating expense estimates were not properly updated, rent concessions were not accounted for in estimating income, and the appraisal was over 120 days old. The division has also found deficiencies with other aspects of the field offices' review, including mortgage credit and architectural problems. These problems included unauthorized financial relationships between borrowers and lenders and noncompliance with building accessibility requirements for the disabled.

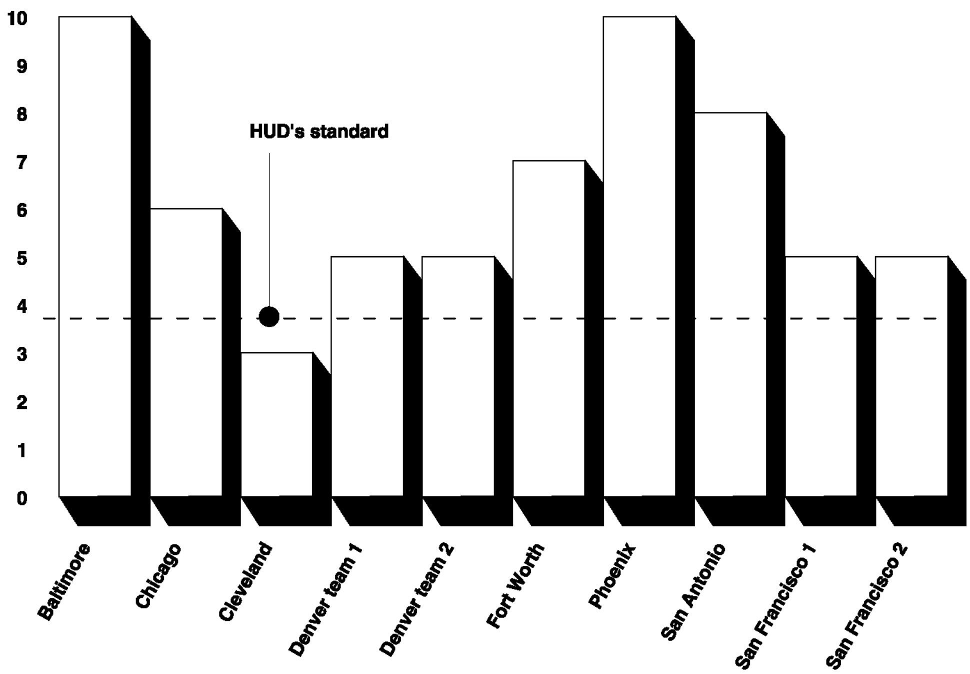
Field Offices' Workloads Often Exceeded HUD's Standard

As previously noted, field office staff cited workload and time constraints as major reasons for some of the implementation problems we found. In addition, some field office managers told us that they needed additional staff to handle their assigned workload. HUD's risk assessment for the MAP program[15] concluded that a MAP team should be able to review up to four mortgage insurance applications at a time and still meet required processing timeframes. To compare the teams' workloads against this standard, we determined the number of applications that each MAP team was reviewing[16] at the time of our visits to the eight field offices. Because two of the field offices had two MAP teams apiece, we reviewed a total of 10 teams. As shown in figure 3, we found that 9 of the 10 teams were reviewing more than four applications. For these 9 teams, the number of applications ranged from 5 in Denver and San Francisco to 10 in Baltimore and Phoenix.

[15]HUD's guidance requires the Department to conduct risk assessments of new or substantially revised programs. The risk assessments are documented reviews by HUD management of a program's susceptibility to waste, fraud, abuse, and mismanagement.

[16]In determining this number, we counted all mortgage insurance applications that were in either the pre-application or firm commitment stage of review at the time of our visits. We visited the Cleveland, San Francisco, Denver, Ft. Worth, and San Antonio field offices in October 2001, and the Chicago, Phoenix, and Baltimore field offices in November 2001.

Figure 3: MAP Team Workloads at Time of GAO's Visits Compared with HUD's Standard



Source: GAO's analysis of data from HUD's multifamily field offices.

Office of Multifamily Housing officials told us that they were aware that some of the field offices had heavy workloads. To address this problem, the officials said that to a limited extent, they had shifted some of this work to staff in field offices with smaller workloads. However, they also acknowledged that as the MAP program grows, they might have to take this action more frequently to balance the workload among the field offices.

HUD Has Not Fully Staffed and Developed Its Quality Assurance Function

In its risk assessment of the MAP program, HUD emphasized the importance of establishing a quality assurance process. The risk assessment indicated, among other things, that quality assurance efforts would promote lenders' compliance with program requirements. However, HUD has not fully implemented its quality assurance process. Specifically, although the Lender Qualifications and Monitoring Division is tasked with implementing this process, it has not (1) achieved its intended staffing level, (2) developed and implemented formal operating procedures, or (3) effectively used the results of its reviews to improve lenders' underwriting of loans.

In developing the MAP program, HUD recognized that it had not committed sufficient resources to lender monitoring in the past. Despite this recognition, the Department has not fully staffed its Lender Qualifications and Monitoring Division, which is tasked with performing quality assurance reviews of loans already approved for FHA insurance. The division's staffing plan envisioned that the reviews would be conducted by 15 field-based staff divided into three teams. However, as of March 2002—almost 2 years after the MAP program's inception—only 4 of the 15 positions had been filled. Although the division performed 24 quality assurance reviews in fiscal year 2001, it had to bring in volunteers from other HUD headquarters and field offices to assist in this work. The division director indicated that the volunteers were not as productive as the permanent staff because they were only temporary and lacked experience in performing reviews. Furthermore, he estimated that with 15 permanent full-time staff, the division could have conducted 75 reviews. The Department has taken steps to deal with the vacant field positions; in February 2002, the division received approval from HUD's Office of the Deputy Assistant Secretary for Multifamily Housing to fill its staff vacancies. According to HUD officials, the Department will begin hiring for these positions in May 2002, but has not established a target date for filling all of the vacancies. The division also has a vacancy in a headquarters position slated to assist the division director with his responsibilities. However, an Office of Multifamily Housing official told us there was no plan to fill the position until other staffing needs in Multifamily Housing were addressed.

According to the division director, these staffing problems have contributed to delays in the division's development of written operating procedures addressing, among other things, how quality assurance reviews should be conducted and how loans and lenders should be targeted for review. Without such procedures, the division cannot ensure that its reviews are performed in a systematic and consistent manner and that its resources are focused on loans and lenders that pose the highest insurance risks to HUD. The division has been in the process of drafting operating procedures since October 2000, but it has relied on a series of individuals detailed from another part of Multifamily Housing to complete this task. According to the division director, turnover in these detailees, the fact that they are not directly accountable to him, competing work priorities, and his lack of an assistant have made it difficult for him to adequately supervise the development of the procedures. At the time of our review, one of the detailees was still working on the procedures but, according to the director, did not have an estimated completion date.

A key objective of the quality assurance reviews is to improve the MAP lender's underwriting of loans by conveying findings and recommendations to the lenders through written reports and by identifying serious or recurring underwriting deficiencies and program violations that may require corrective action. In addition, the reviews are also intended to evaluate the field office's compliance with procedures for approving lenders' mortgage insurance applications under the MAP program. However, the Lender Qualifications and Monitoring Division is not fully meeting this objective because it has been slow to communicate the results of its reviews to MAP lenders and field offices and has done limited analysis of the results. For example, during fiscal year 2001, staff completed 24 reviews and submitted draft reports for all of these reviews to the division director for approval and issuance. According to division field staff, conducting a review and drafting the associated report takes about 2 weeks. However, as of March 2002, the division had issued final reports for only 6 of the 24 reviews, even though all 18 of the remaining reviews had been conducted over 6 months earlier. In two cases, the reviews were done over a year earlier. According to the division director, the remaining draft reports have not been finalized because he has not had time to review them. However, by not issuing the reports, HUD is not providing lenders and field offices with timely feedback on problems uncovered by these reviews that may increase HUD's insurance risk. In addition, the division has not developed a systematic process for aggregating and analyzing the results of its reviews to identify patterns of deficiencies. As a result, it has done limited analysis of the 24 completed reviews to identify recurring underwriting errors and program violations committed by MAP lenders. Even these limited efforts demonstrate the benefits of this kind of analysis. For example, the division observed that several lenders had not, as required, determined whether the properties HUD was insuring complied with accessibility requirements mandated by the Fair Housing Act. Accordingly, the division sent a notice to all MAP lenders reemphasizing the lenders' responsibility for ensuring compliance with the accessibility requirements. However, further analysis of its reviews would be difficult—particularly as the number of completed reviews increases—without storing the results in an automated spreadsheet or database.

HUD Has Held Some Lenders Accountable for Specific Violations, but Has Had a Limited Basis for Identifying Lenders with Patterns of Noncompliance

To hold MAP lenders accountable for specific violations of program requirements or for exhibiting patterns of noncompliance, HUD's Office of Multifamily Housing can suspend or terminate their ability to participate in the MAP program. Multifamily Housing has suspended some MAP lenders for specific violations. In contrast, it has neither terminated nor suspended any lenders for exhibiting patterns of noncompliance, because weaknesses in its quality assurance process and the newness of the MAP program have provided a limited basis for identifying such patterns.

HUD Has Suspended Some Lenders for Specific Violations

HUD's guidance allows the Office of Multifamily Housing to suspend or terminate a lender's participation in the MAP program for specific violations of program requirements. The type of penalty HUD imposes against a lender depends on the severity of the violation and the degree to which it affects HUD's financial risk. According to HUD's guidance, violations that directly and adversely affect HUD's risk may result in termination; violations that do not pose such a risk may result in suspension.

As of March 2002, HUD had not terminated any MAP lenders, but it had suspended three. Two of the three lenders were suspended because they had prohibited financial relationships with the borrowers. The third lender was suspended because it did not follow HUD's insurance application process for health care facilities. Specifically, it submitted mortgage insurance applications without first obtaining the required HUD approval of the management agent of these facilities. The duration of the suspensions range from 6 to 12 months. During the term of their suspensions, these lenders are prohibited from submitting additional mortgage insurance applications under the MAP program. The suspensions do not affect insurance applications already being processed by HUD's field offices. The three suspensions are a result of lender noncompliance with MAP program requirements identified by Lender Qualifications and Monitoring Division staff.

Multifamily Housing officials told us that taking enforcement actions consumes considerable staff time and effort, partly because the actions must be supported well enough to withstand potential court challenges by the lenders. According to HUD officials, two of the three lenders that HUD suspended have challenged the Department's actions in federal district court. In one case, the lender ultimately withdrew its challenge and served its suspension. In the other case, as of April 2002, the court had not made a ruling, according to Multifamily Housing officials. The officials said they would continue to pursue enforcement actions against MAP lenders that do not comply with HUD's requirements because the success of the MAP program depends heavily on the integrity of the participating lenders.

HUD Has Had a Limited Basis for Determining Any Patterns of Noncompliance

HUD's guidance emphasizes the importance of terminating or suspending lenders that exhibit a pattern of noncompliance over several insurance applications. According to the guidance, examples of noncompliance may include

- failure to provide required loan exhibits, or submission of incomplete or inaccurate exhibits;
- lack of appropriate documentation and analysis for underwriting conclusions;
- evidence that a lender's unsound underwriting resulted in the assignment of an FHA-insured mortgage loan to HUD.

Reviews conducted by the Lender Qualifications and Monitoring Division have revealed instances where lenders made underwriting errors, including missing and inaccurate loan exhibits and inadequately supported underwriting conclusions. However, as previously discussed, the division has issued final reports for only a few of its quality assurance reviews and lacks a systematic process for aggregating and analyzing the results of its reviews. Consequently, HUD has had a limited basis for identifying any patterns of noncompliance and, as of March 2002, had not taken enforcement actions against lenders for exhibiting such patterns. The newness of the MAP program has also limited HUD's ability to identify patterns of deficiencies, because patterns take time to emerge and may only become evident after HUD has performed quality assurance reviews on several of a lender's loans. Furthermore, because no MAP loans have been assigned to HUD so far—partly a consequence of the young age of loans—the Department has no evidence that unsound underwriting practices are resulting in failed loans.

Conclusions

FHA insures several billion dollars in mortgages for multifamily housing properties each year. Given the size of this financial commitment and the MAP program's delegation of significant loan underwriting responsibilities to lenders, it is important that HUD have sufficient controls to mitigate the program's financial risks. Although HUD has established processes and procedures for this purpose, it has not always consistently or effectively implemented them. Weaknesses in HUD's lender approval and monitoring efforts, in particular, underscore the need for improvements in its oversight of MAP lenders.

HUD did not always ensure that the lenders it approved to participate in the MAP program met HUD's qualification requirements for underwriters. Because the Department's guidance does not provide clear standards for assessing the experience of lenders' underwriters, HUD staff applied the guidance inconsistently. In addition, HUD did not ensure that approved underwriters attended required training sessions before submitting insurance applications. When qualification standards are not clear and strictly enforced, HUD increases the potential that MAP underwriters will not be familiar with program requirements and will make errors that could increase HUD's review time and insurance risk. Although the success of the MAP program rests heavily on the quality of its participating lenders, HUD did not require these lenders to implement quality control plans and did not establish standards for these plans. We believe that implementing such a requirement would help ensure that MAP lenders have the necessary policies and procedures to prevent underwriting deficiencies that could increase HUD's insurance risk.

HUD could improve its implementation of processes for reviewing and monitoring MAP lenders' underwriting of loans. Because field office staff did not always document their reviews of mortgage insurance applications, as required, HUD lacked full assurance that the reviews were thorough and that its decisions to insure loans were properly supported. In addition, field staff did not enforce lenders' compliance with some requirements for property appraisals, including those designed to ensure that expense estimates for the property being insured are accurate. These problems occurred, in part, because of unclear guidance and heavy workloads. Because a property's income and expenses are major factors in determining the size of the mortgage, inaccurate estimates can increase HUD's risk of insuring mortgages that are higher than what the property can support. The consequence of this increased risk is higher potential program costs. Finally, HUD's monitoring of lenders and field offices through quality assurance reviews has several weaknesses. These weaknesses—including insufficient staff, a lack of formal operating procedures, lengthy delays in issuing reports, and minimal analysis of review results—have limited HUD's ability to oversee the MAP program.

Recommendations for Executive Action

To improve HUD's oversight of MAP lenders and to reduce the financial risks assumed by FHA, we recommend that the Secretary of HUD direct the Assistant Secretary for Housing-Federal Housing Commissioner to do the following:

- Strengthen the process for approving MAP lenders by (1) issuing guidance that clarifies HUD's experience requirements for MAP underwriters and requires HUD staff to evaluate prospective MAP underwriters against these standards; and (2) issuing guidelines that establish standards for quality control plans and require MAP lenders to develop and maintain these plans as a condition of continued participation in the MAP program.
- Improve field offices' implementation of procedures for reviewing mortgage insurance applications submitted by MAP lenders, by (1) holding MAP team leaders accountable for preparing required review memos, and for ensuring that HUD field office staff consistently use review checklists in accordance with MAP guidance; (2) utilizing data in HUD's Financial Assessment Subsystem to corroborate expense data for HUD-insured or -assisted properties used as comparable properties in appraisal reports; and (3) clarifying and enforcing HUD's requirement for updating the operating expense estimate for a subject property to the date of the appraisal.
- Strengthen the Lender Qualifications and Monitoring Division's monitoring of lenders and HUD field offices, by (1) establishing a time frame for finalizing and issuing written operating procedures that include criteria for selecting loans and lenders for review that pose a high insurance risk to the Department; (2) issuing written reports on all quality assurance reviews conducted in fiscal year 2001 to the cognizant MAP lenders and HUD field offices; and (3) developing a process for aggregating and analyzing the results of quality assurance reviews to identify patterns of underwriting deficiencies and program violations by MAP lenders.

Agency Comments

We provided HUD with a draft of this report for its review and comment. HUD indicated that it agreed with each of the report's recommendations and that it had begun taking actions to address them.

In response to our recommendations to strengthen the process for approving MAP lenders, HUD said it (1) would centralize the authority for the initial approval of MAP underwriters within HUD headquarters, and would issue guidance to MAP lenders and HUD staff that clarifies HUD's experience requirements for underwriters; and (2) was working with the Mortgage Bankers Association of America to develop requirements and standards for quality control plans for MAP lenders. HUD also indicated that MAP lenders that failed to submit, maintain, or operate in accordance with an acceptable quality control plan would be removed from the program.

In response to our recommendations to improve field offices' implementation of procedures for reviewing mortgage insurance applications submitted by MAP lenders, HUD indicated that it (1) had instructed field office directors to ensure MAP team leaders' and technical specialists' adherence to procedures for documenting reviews of MAP insurance applications, and would issue a notice to the field offices emphasizing the necessity of following these procedures; (2) would begin using data in HUD's Financial Assessment Subsystem to corroborate the expense data for HUD-insured properties used as comparable properties in appraisal reports; and (3) would issue guidance to MAP lenders detailing the correct method for updating a property's operating expenses.

In response to our recommendations to strengthen the Lender Qualifications and Monitoring Division's monitoring of lenders and HUD field offices, HUD said it (1) had established a target date of December 15, 2002, for issuing written procedures that include criteria for selecting lenders and loans that pose a high insurance risk to HUD; (2) would expedite the issuance of reports from quality assurance reviews conducted in fiscal year 2001; and (3) was developing a spreadsheet to aggregate and analyze findings from quality assurance reviews. The full text of HUD's letter is presented in appendix I.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days after the date of this letter. At that time, we will send copies to the Secretary of Housing and Urban Development. We will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please call me at (202) 512-7631. Key contributors to this report are listed in appendix III.

Stanley J. Czerwinski
Director, Physical Infrastructure Issues

Appendix I: Comments from the Department of Housing and Urban Development

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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

JUN 19 2002

Mr. Stanley J. Czerwinski
Director
Physical Infrastructure Issues
United States General Accounting Office
Washington, DC 29548

Dear Mr. Czerwinski:

We appreciate the opportunity to comment on the July 2002 draft of GAO's report on Multifamily Housing Improvements Needed in HUD's Oversight of Lenders that Underwrite FHA-Insured Loans (GAO-02-680), hereafter called "the GAO report."

The GAO report reflected an excellent understanding of the procedures under HUD's Multifamily Accelerated Processing (MAP) for FHA's multifamily mortgage insurance programs. These comments do not question the findings in the GAO report. Instead, HUD's specific comments are devoted to the ways that HUD will implement the recommendations for executive action in the GAO report.

We believe that the use of MAP assures a higher level of safety in underwriting than existed before MAP. For one reason, MAP Lenders must go through a strict approval process. Lenders without extensive multifamily underwriting experience will not be approved. Second, MAP established uniform standards of case review to be applicable in each Multifamily Hub and Program Center. Prior to the implementation of MAP, Hubs and Program Centers used "fast-track" procedures, which differed from field office to field office, resulting in uneven application of review procedures. Third, MAP has a monitoring staff which provides a post-review sampling of MAP closed loans to help assure careful underwriting by both Lenders and HUD staff.

We are giving particular attention to the insurance on health care facilities. There are now new MAP requirements insuring an extra level of review of MAP underwriters who underwrite health care facilities, and there are detailed additional requirements for owners who seek to finance or refinance 11 or more of these projects with a total of $75 million, or more.

Design of MAP was based on the well established and proven multifamily underwriting systems of the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal National Mortgage Association (Fannie Mae), both of which utilize a limited number of experienced lenders. MAP is more closely aligned to the Freddie Mac system, wherein the final approval is retained by Freddie Mac. Fannie Mae allows the lender to make this approval, but requires the lender to risk-share losses.

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Obtaining high quality loan applications depends on efficient processing. Processing of all multifamily insurance under the traditional FHA method resulted, in some field offices, in delays of as much as a year from application to closing. Allowing the Lenders to prepare and review many of the application documents under MAP made a sizeable difference in processing time. A condition of Lender application preparation and review is careful review of the Lender's actions by the HUD staff.

We are confident that the review of MAP loans has been, and will continue to be, more than adequate to protect the FHA insurance fund. The GAO report, nevertheless, is particularly helpful in pointing out areas of review where greater care or additional documentation of actions taken is needed. The specific comments that follow explain the steps we have taken, or intend to take, to implement the GAO recommendations.

Recommendation:

Strengthen the process for approving MAP lenders by (1) issuing guidance that clarifies HUD's experience requirements for MAP underwriters and requires HUD staff to evaluate prospective MAP underwriters against these standards and (2) issuing guidelines that establish standards for quality control plans and require MAP lenders to develop and maintain these plans as a condition of continued participation in the MAP program.

HUD's Response:

The Department accepts the GAO recommendation to issue guidance that clarifies HUD's experience requirements for MAP underwriters and requires HUD staff to evaluate prospective MAP underwriters against these standards. We will issue a Mortgagee Letter providing this guidance. Furthermore, it is our intention to remove the Field Office authority to initially approve a MAP Lender's underwriter. In the future, only HUD Headquarters will be authorized to approve a MAP Underwriter. We estimate this task will be completed by October 15, 2002.

The Department accepts the GAO recommendation to issue guidelines that establish standards for MAP Lender quality control plans and require MAP lenders to develop and maintain these plans as a condition of continued participation in the MAP program. We asked the Mortgage Bankers Association of America (MBA) to establish a working group to recommend to the Department standards for quality control plans. The group has met and has a series of questions/discussion points for us to consider. Once the standards are developed, a Mortgagee Letter will be issued requiring that the standards be used in developing quality control plans. MAP Lenders will be required to submit a quality control plan based on these standards to the Department. Once the plan is approved by HUD, the MAP Lender will be required to maintain and operate it in accordance with its elements. Those MAP Lenders failing to submit, maintain, or operate in accordance with an acceptable quality control plan will be removed from the program. We estimate the task of promulgating the Mortgagee Letter will be completed by November 15, 2002.

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Recommendation:

Improve field offices' implementation of procedures for reviewing mortgage insurance applications submitted by MAP lenders by (1) holding MAP team leaders accountable for preparing required review memos and for ensuring that HUD field office staff consistently use review checklists in accordance with MAP guidance, (2) utilizing data in HUD's Financial Assessment Subsystem to corroborate expense data for HUD-insured or assisted properties used as comparable properties in appraisal reports, and (3) clarifying and enforcing HUD's requirement for updating the operating expense estimate for a subject property to the date of the appraisal.

HUD's Response:

The Department accepts the GAO recommendation of holding MAP team leaders accountable for preparing required review memos and for ensuring that HUD field office staff consistently use review checklists in accordance with MAP guidance. To reinforce the importance that we place on performing these actions, the Department has taken the following steps:

- The Department held a meeting for the HUD Multifamily Hub Directors in Washington, DC, May 21 through 23, 2002. During this meeting, the Headquarters staff shared the preliminary GAO draft MAP findings with the Hub Directors. The Directors also were given a refresher course on the MAP HUD review documentation procedures. They were instructed to take actions to ensure that all Team Leader memos and technical specialist review checklists were completed in accordance with the MAP Guide.

- The Department held several video teleconferencing sessions (PicTel broadcasts) with small groups of Hubs and their respective Program Center MAP staff. In each of these sessions, the GAO preliminary draft findings were reviewed and completion of the memoranda and checklists was mandated of Team Leaders and technical staff participating in these sessions. The PicTel broadcasts with all of the Hubs and Program Centers were conducted between May 30 and June 14, 2002.

- A Housing Notice will be published in the coming weeks and sent to the HUD field offices emphasizing the necessity of filing timely reports, memoranda and checklists on a consistent basis in accordance with the MAP Guide and Supplements. It will address the GAO findings and remind Team Leaders and technical staff of their responsibility to document MAP reviews in accordance with established policy.

The Department accepts the GAO recommendation of utilizing HUD's Financial Assessment Subsystem data to corroborate the expense data for HUD-insured properties used on comparable properties in appraisal reports. The Department has begun the process of assigning passwords to multifamily appraisers throughout HUD field offices to give them access to the Financial Assessment Subsystem. While not all data may be compatible on a line for line basis, we expect full field utilization will be completed by August 30, 2002 for intermediate groupings of items such as total utility costs and total maintenance costs.

The Department accepts the GAO recommendation of enforcing the requirement for updating the operating expense estimate for a subject property to the date of the appraisal in accordance with the specific instructions contained in the MAP Guide. Accordingly, we have informed the Hub Directors to direct their staff to ensure that comparable expenses are appropriately updated in the process of deriving total estimated project expenses for MAP appraised properties. This was one of several items covered in the Hub Directors conference in May, during the PicTel broadcasts with field staff, and it will be covered again in a forthcoming Mortgagee Letter to all MAP Approved Lenders detailing the correct method of updating comparable expenses for all third party appraiser contractors.

Recommendation:

Strengthen the HUD Multifamily Development, Lender Qualifications and Monitoring Division's (LQMD) monitoring of lenders and HUD field offices by (1) establishing a time frame for finalizing and issuing written operating procedures that include criteria for selecting loans and lenders for review that pose a high insurance risk to the Department, (2) issuing written reports on all quality assurance reviews conducted in fiscal year 2001 to the cognizant MAP lenders and HUD field offices, and (3) developing a process for aggregating and analyzing the results of quality assurance reviews to identify patterns of underwriting deficiencies and program violations by MAP lenders.

HUD's Response:

The Department accepts GAO's recommendation to establish a time frame for finalizing and issuing written operating procedures that include criteria for selecting loans and lenders for review that pose a high insurance risk to the Department. We have established a completion date of December 15, 2002 for this monitoring guide.

The Department accepts the GAO recommendation to issue written reports on all quality assurance reviews conducted in fiscal year 2001 to the cognizant MAP lenders and HUD field offices. As of June 19, 2002, fourteen LQMD Reports from FY 2001 remain to be finalized and issued. The Department expects to issue the remaining reports at a pace of two reports a week. Since February 2002, the LQMD team leaders send the draft report to the Hub/Program Center Director for review and comment. The Director is given 30 days to respond to the report, and the Director's comments are considered in the final report.

The Department accepts the GAO recommendation to develop a process for aggregating and analyzing the results of quality assurance reviews to identify patterns of underwriting

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deficiencies and program violations by MAP lenders. LQMD is developing an Excel generated spreadsheet to aggregate and analyze the findings from LQMD monitoring reports. We will be able to analyze these findings by MAP Lender, MAP Underwriter or type of finding.

We appreciate your comments and recommendations.

Sincerely,

John C. Weicher
Assistant Secretary for Housing - Federal Housing Commissioner

Appendix II: Objectives, Scope, and Methodology

Our objectives were to answer the following questions: (1) How well does the Department of Housing and Urban Development (HUD) ensure that lenders participating in the Multifamily Accelerated Processing (MAP) program meet HUD's qualification requirements? (2) How well is HUD implementing processes for reviewing and monitoring MAP lenders' underwriting of loans? (3) Has HUD held any MAP lenders accountable for noncompliance with program requirements?

To determine how HUD ensures that MAP lenders meet HUD's qualifications requirements, we reviewed HUD's regulations, guidance, and procedures relating to its process for approving lenders to participate in the MAP program. We interviewed officials from HUD's Office of Lender Activities and Program Compliance, the Office of Multifamily Housing's Lender Qualifications and Monitoring Division, and multifamily field offices in Baltimore, Chicago, Cleveland, Denver, Ft. Worth, Phoenix, San Antonio, and San Francisco. To assess how HUD implemented its process for approving MAP lenders, we focused on the 20 lenders that made the 35 new construction and substantial rehabilitation loans insured under the MAP program by the eight field offices between May 2000 and August 2001. For each of the 20 lenders, we reviewed its application and supporting documents for MAP approval; comments solicited from the field offices about it; and HUD's records showing the approval of the lender and its underwriters for participation in the program. In addition, we used information from HUD's F47 database—which provides current and historical information on the multifamily mortgage loans that FHA insures—to verify that the lenders reported all of their FHA-insured loans made during the previous 5 years that were assigned to HUD. We also examined HUD's training records to determine whether the 22 underwriters who underwrote the 35 loans we reviewed had received MAP program training. Finally, to determine whether HUD had obtained quality control plans from the lenders, we reviewed files maintained by the Department's Lender Approval and Recertification Division.

To determine how well HUD implemented processes for reviewing and monitoring MAP lenders' underwriting of loans, we reviewed HUD's guidance and procedures for the field offices' review and approval of mortgage insurance applications. We also interviewed officials from HUD's Office of Multifamily Housing and each of the eight field offices we visited regarding how the reviews are conducted and documented, as well as workload and staffing issues. To assess how HUD implemented the application review process, we focused on the 35 new construction and substantial rehabilitation loans insured under the MAP program by the eight field offices between May 2000 and August 2001. For each of these cases, we reviewed the lender's mortgage insurance application and associated underwriting exhibits and documentation of HUD's review and approval of the applications, including review checklists and team leader memos. To assess the extent to which the field offices ensured lenders' compliance with HUD's underwriting requirements, we focused on four requirements for property appraisals, a critical aspect of loan underwriting. Specifically, we determined whether the appraisals: 1) used rent and expense information from at least three comparable properties as a basis for estimating the expected rental income and operating expenses of the subject property; 2) updated the expense estimate for the subject property to the date of the appraisal; 3) accounted for the comparable properties' occupancy rates and rent concessions in estimating rental income for the subject property; and 4) were no more than 120 days old at the time the insurance application reached the firm commitment stage. In making these determinations, we corroborated the rent data used in the appraisals using information in apartment rental guides and Web sites and by contacting apartment leasing offices. Similarly, we corroborated expense data for HUD-insured or -assisted properties used in the appraisals against audited financial statements in HUD's Financial Assessment Subsystem. We discussed our findings with the field office staff responsible for reviewing the appraisals. Also, we compared the field offices' workloads at the time of our visits against the workload standard set forth in HUD's risk assessment for the MAP program. In addition, we reviewed the results of reviews conducted by the Lender Qualifications and Monitoring Division to identify underwriting deficiencies uncovered by HUD's quality assurance process. To determine how well HUD monitored lenders and field offices through its quality assurance process, we interviewed officials from the Office of Multifamily Housing and its Lender Qualifications and Monitoring Division to discuss how the division conducts its reviews. In addition, we compared the division's planned staffing level with its actual level as of March 2002. We obtained data on the number and status of quality assurance reviews that the division planned and conducted in fiscal year 2001 and the number of these reviews for which the division issued reports to the cognizant MAP lenders and field offices.

To determine whether HUD has held any MAP lenders accountable for noncompliance with program requirements, we reviewed HUD's regulations and guidance to determine the enforcement options available to HUD. We interviewed officials from HUD's Office of Multifamily Housing to discuss the enforcement actions that had been taken against MAP lenders as of March 2002. We also reviewed documentation regarding the specific circumstances that led to these actions.

We tested the data we obtained from HUD for reasonableness and completeness and found them to be reliable for the purpose of our analyses. In addition, we reviewed existing information about the quality and controls supporting the data systems and discussed the data we analyzed with agency officials to ensure that we interpreted them correctly.

We conducted this review from April 2001 through April 2002 in accordance with generally accepted government auditing standards.

Appendix III: GAO Contacts and Staff Acknowledgments

GAO Contacts

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In addition to those named above, Mark Egger, Tiffani Green, Rick Hale, Laura Hogshead, Donna Leiss, Bill McDaniel, John McGrail, Andy O'Connell, Jerry Patton, Rose Schuville, Stewart Seman, Jim Vitarello, Wendy Wierzbicki, and Steve Westley made key contributions to this report.

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