United States Government Accountability Office

GAO

Report to Congressional Addressees

November 2004

SINGLE-FAMILY HOUSING

Progress Made, but Opportunities Exist to Improve HUD's Oversight of FHA Lenders

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Highlights

Highlights of GAO-05-13, a report to congressional addressees

Why GAO Did This Study

Every year, the Department of Housing and Urban Development (HUD), through its Federal Housing Administration (FHA), insures billions of dollars in home mortgage loans made by private lenders. Oversight of lenders has historically been a challenge for HUD. In January 2003, GAO reported that, due in part to poor lender oversight, HUD's single-family mortgage insurance programs remained a high-risk area. This report examines (1) how well HUD follows its guidance when granting lenders direct endorsement authority (the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review), (2) the extent to which HUD uses a risk-based approach when monitoring FHA lenders, and (3) the extent to which HUD holds accountable lenders that it identifies as not complying with its performance requirements.

What GAO Recommends

This report includes five recommendations designed to improve HUD's processes for approving and monitoring FHA mortgage lenders and for sanctioning them for unacceptable performance. In responding to a draft of this report, HUD agreed with the recommendations but commented that the report does not fully recognize the accomplishments resulting from its changes to lender oversight.

www.gao.gov/cgi-bin/getrpt?GAO-05-13.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at (202) 512-8678 or woodd@gao.gov.

November 2004

SINGLE-FAMILY HOUSING

Progress Made, but Opportunities Exist to Improve HUD's Oversight of FHA Lenders

What GAO Found

HUD has not consistently followed its guidance for granting direct endorsement authority. The guidance requires that, to receive the authority, lenders must, within a 1-year period, submit for HUD's approval at least 15 mortgage loans that HUD assesses "good" or "fair" using its assessment criteria, including the last 5 consecutive loans. However, we found that HUD deviated from this guidance when granting authority to some of the 49 lenders that were approved between October 1, 2002, and April 30, 2004. For example, HUD granted authority to 7 lenders who did not submit the minimum 15 loans rated "good" or "fair."

HUD has been using a risk-based approach to monitoring lenders, employing, among other things, aggregate loan performance data to target lenders for review. However, certain factors limit the usefulness of its monitoring tools. First, the rating system HUD uses when performing technical reviews—desk audits to evaluate the underwriting quality of loans insured by FHA—does not currently reflect the different levels of risk that detected underwriting errors pose to the insurance fund. HUD is in the process of revising the system to improve its usefulness. Second, while GAO found that, in fiscal year 2003 and the first half of fiscal year 2004, HUD generally reviewed those lenders that met its targeting criteria, its reports on lender reviews do not distinguish between those conducted on-site (at lenders' offices) and off-site ("desk" reviews). HUD's guidance allows desk reviews, but on-site reviews are preferred because, among other things, they allow for direct observation and the ability to easily review more loans. HUD's reports do not identify the number of off-site reviews, but a manual search of records showed that 70 of the 910 lender reviews conducted in fiscal year 2003 were off-site reviews.

HUD's efforts to hold poor performing lenders accountable have not been comprehensive. HUD has made limited use of its ability to suspend the direct endorsement authority of noncompliant lenders, suspending 7 (of about 2,900 lenders with direct endorsement authority) in fiscal year 2003 and the first half of fiscal year 2004. Further, HUD's Mortgagee Review Board can take over a year to take action, during which time noncompliant lenders may continue to make FHA-insured loans.

Contents

Abbreviations

CHUMS	Computerized Homes Underwriting Management System
FHA	Federal Housing Administration
HECM	Home Equity Conversion Mortgage
HUD	Department of Housing and Urban Development

United States Government Accountability Office
Washington, D.C. 20548

November 12, 2004

The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Michael G. Oxley
Chairman
The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

Every year, the Department of Housing and Urban Development (HUD), through its Federal Housing Administration (FHA), insures billions of dollars in home mortgage loans made by private lenders.[1] During fiscal year 2003 alone, FHA insured over 1.3 million mortgages valued at about $160 billion. While FHA insures lenders against nearly all losses resulting from foreclosed loans, it relies on the lenders to underwrite the loans and determine their eligibility for FHA mortgage insurance.[2] Oversight of FHA lenders has historically been a challenge for HUD. In April 2000, we reported on weaknesses in HUD's lender approval, monitoring, and enforcement efforts.[3] We also reported in January 2003 that, due in part to poor lender oversight, HUD's single-family mortgage insurance programs remained a high-risk area for HUD.[4] Furthermore, HUD's Office of Inspector General noted in its most recent semiannual report to Congress

[1]FHA is a part of HUD, and the Assistant Secretary for Housing is also the Federal Housing Commissioner.

[2]Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.

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

[4]GAO, *High-Risk Series: An Update*, GAO-03-119 (Washington, D.C.: Jan. 1, 2003).

that FHA's single-family mortgage insurance programs continue to be a major management challenge for the department.[5]

While over 10,000 lending institutions are approved to participate in FHA's single-family mortgage insurance programs, only about 2,900 of these institutions have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review. Lenders with this authority underwrite virtually all FHA-insured mortgages for single-family homes. This report examines (1) how well HUD follows its guidance when granting lenders direct endorsement authority, (2) the extent to which HUD uses a risk-based approach when monitoring the lenders participating in FHA's mortgage insurance programs, and (3) the extent to which HUD is holding lenders that it identifies as not complying with its requirements accountable for their performance. We conducted this review on the initiative of the Comptroller General.

To address our objectives, we reviewed the activities of HUD's headquarters and its four homeownership centers in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California, which administer HUD's single-family housing activities in all 50 states, the District of Columbia, and Puerto Rico. At each homeownership center, we reviewed the documentation maintained on lenders to which HUD had recently granted direct endorsement authority. We also obtained and analyzed data on the lenders that HUD had targeted for reviews and on the loans HUD had selected for technical reviews in fiscal year 2003 and the first two quarters of fiscal year 2004. Finally, we reviewed case files acted on by the Mortgagee Review Board—an enforcement body chaired by HUD's Assistant Secretary for Housing-Federal Housing Commissioner. We assessed the reliability of the HUD data we used by discussing the data with knowledgeable agency officials, reviewing information about the systems, and performing electronic testing to detect obvious errors in completeness and reasonableness. We determined that the data were sufficiently reliable for the purposes of this report.

[5]U.S. Department of Housing and Urban Development, Office of Inspector General, *Semiannual Report to Congress, October 1, 2003 through March 31, 2004* (Washington, D.C.).

We performed our work from December 2003 to September 2004 in accordance with generally accepted government auditing standards. Appendix I provides additional details on our scope and methodology.

Results in Brief

HUD's homeownership centers are not consistently following the department's guidance for granting direct endorsement authority. FHA-approved lenders must demonstrate "acceptable performance" in underwriting at least 15 mortgage loans before receiving direct endorsement authority. HUD's four homeownership centers perform evaluations, known as preclosing reviews, of these loans in order to assess lenders' performance. According to HUD's guidance, acceptable performance is defined as submitting a minimum of 15 loans that are rated "good" or "fair" within a 1-year probationary period, with the last 5 consecutive cases rated "good" or "fair." We found, however, that the homeownership centers have not consistently followed this guidance, based on our analysis of the preclosing reviews performed for all 49 lenders that entered the probationary period on or after October 1, 2002, and were granted direct endorsement authority by April 30, 2004. For example, 7 of the 49 lenders were granted direct endorsement authority, although they did not submit the minimum 15 loans rated "good" or "fair."

HUD uses a risk-based approach to monitoring lenders, employing aggregate loan performance data, complaints of irregularities or fraudulent practices, the results of technical reviews of individual loans, and/or other factors to target lenders for review. However, certain factors limit the usefulness of its monitoring tools.

- *HUD's technical reviews do not distinguish between different levels of risk.* Technical reviews are desk audits to evaluate the underwriting quality of individual loans insured by FHA. In February 2004, HUD implemented an algorithm that allows it to select loans for technical reviews based on certain risk factors, such as loans made to first-time homebuyers and adjustable rate mortgages. However, the ratings that are assigned during technical reviews do not currently reflect the different levels of risk that underwriting errors pose to the insurance fund. According to our analysis of technical reviews conducted in fiscal year 2003 and the first two quarters of fiscal year 2004, 70 percent of the loans rated on mortgage credit analysis received "poor" ratings, meaning that the lenders made mistakes in evaluating the borrowers' creditworthiness. Under the current rating system, there is no way to distinguish a "poor" that represents a deficiency posing a risk to the insurance fund from a “poor” that represents a compliance or documentation issue (such as an undated or unsigned form). The homeownership centers are in the process of revising the rating system to make it more risk-based. Despite their numbers—over 130,000 in fiscal year 2003 and the first two quarters of fiscal year 2004—technical reviews serve a limited purpose and do not help HUD identify loans that have a high probability of default or loans susceptible to fraud.

- *HUD’s reports on lender reviews do not distinguish between on-site and desk reviews.* One of HUD’s primary tools for evaluating the quality of lenders’ mortgage-lending practices is lender reviews, which are generally on-site evaluations of lenders’ operations. Since May 2000, the homeownership centers have been selecting lenders for lender reviews based on their default and claim rates on FHA-insured mortgages. We found that, in fiscal year 2003 and the first half of fiscal year 2004, HUD generally reviewed those lenders that met its targeting criteria. However, HUD’s reports on lender reviews do not identify the number of reviews that were performed as desk reviews (off-site reviews). Although HUD’s guidance allows staff to complete desk reviews of lenders’ operations, the guidance and homeownership center officials acknowledge that on-site reviews at the lender’s main office or branch are the preferred method of monitoring lenders’ operations. Because HUD’s reports do not routinely track the number of desk reviews, HUD officials conducted a manual search of their records and determined that 70 of the 910 lender reviews conducted in fiscal year 2003 were off-site reviews.

HUD’s efforts to hold poorly performing lenders accountable for their performance have not been comprehensive. HUD has recently proposed changes to improve the effectiveness of its Credit Watch program—an enforcement tool used to terminate the loan origination authority of lenders with excessive default and claim rates on FHA-insured loans. Specifically, it has proposed holding the lenders that underwrote the loans, in addition to the lenders that originated the loans, accountable for excessive defaults or insurance claims. Although HUD’s guidance allows the homeownership centers to suspend the direct endorsement authority of lenders that fail to comply with FHA’s underwriting requirements, the homeownership centers have made limited use of this ability. In fiscal year 2003 and the first two quarters of fiscal year 2004, the Philadelphia homeownership center suspended the direct endorsement authority of seven lenders; however, the other three homeownership centers did not take this action against any lenders. Additionally, the Mortgagee Review

Board's (Board) process for sanctioning lenders is time consuming. The Board, which can impose administrative sanctions against lenders, has taken over a year to complete its actions, during which time the lender can continue to make dozens of loans.

This report contains recommendations designed to improve HUD's processes for approving and monitoring FHA mortgage lenders and sanctioning them for unacceptable performance. We provided HUD with a draft of this report for review and comment. HUD agreed with our recommendations but disagreed with some of our findings and stated that the report does not fully recognize the accomplishments resulting from changes it has made to lender oversight. We did not change our findings because HUD provided no new evidence, and we believe that the report appropriately recognizes the progress HUD has made.

Background

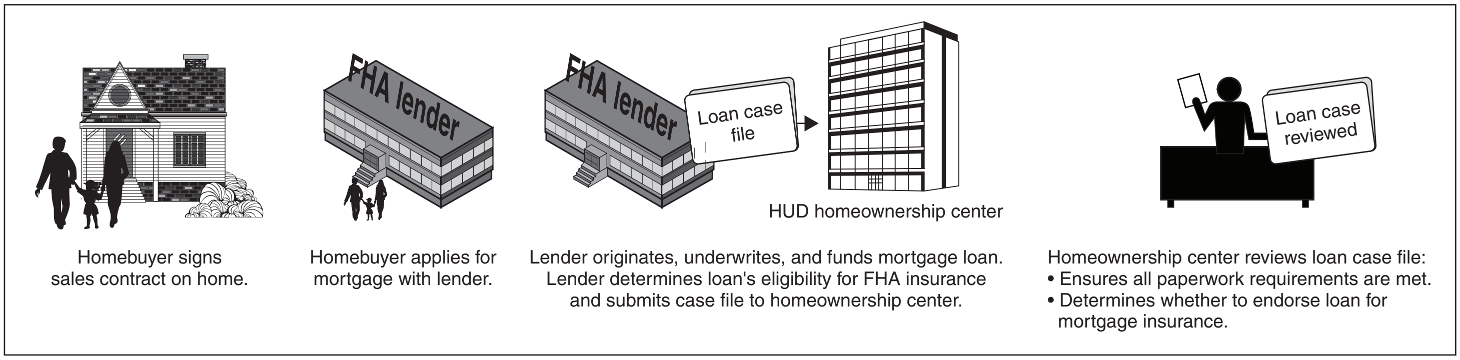
Established by the National Housing Act, FHA insures lenders against losses on mortgages for single-family homes.[6] Lenders usually require mortgage insurance when a homebuyer has a down payment of less than 20 percent of the value of the home. FHA mortgage insurance allows a homebuyer to make a modest down payment and obtain a mortgage for the balance of the purchase price. FHA plays a particularly large role in certain market segments, including low-income borrowers and first-time homebuyers. During fiscal years 2001 to 2003, the number of single-family mortgage loans that FHA insured annually averaged about 1.2 million. For the 3 years combined, FHA insured about 3.7 million mortgages with a total value of about $425 billion.

A homebuyer seeking a FHA-insured mortgage must submit a mortgage application to a FHA-approved lender. Once the lender approves the loan, it sends the loan documents to HUD for approval of FHA mortgage insurance. (See fig. 1.) If the borrower defaults and the lender subsequently forecloses on the loan, the lender can file an insurance claim with HUD for the unpaid balance of the loan. FHA insures most of its mortgages for single-family housing under its Mutual Mortgage Insurance Fund (Fund). To cover lenders' losses, FHA collects insurance premiums that borrowers pay to lenders and deposits the premiums in the Fund. The Fund has historically been self-sufficient. An actuarial study by Deloitte & Touche

[6]Single-family loans insured by FHA may be used to finance the purchase of new or existing one-to-four-family properties. 12 U.S.C. 1709(b).

LLP for fiscal year 2003 indicated that the Fund exceeded the legislative target for capital reserves.[7]

Figure 1: FHA Mortgage Application Process



Sources: GAO (data) and Nova Development Corp. (images).

Lenders must obtain approval from HUD to participate in FHA's mortgage programs. In addition to an application form and fee, lenders are required to submit supporting documentation, including the resumes of senior corporate officers; certified financial statements; and photographs and floor plans of the lender's main office. HUD uses this information to determine whether the applicants meet FHA's requirements for lending experience; financial worth; and adequacy of facilities, among other things. All applicants also must have a written quality control plan that meets FHA's requirements. Additionally, HUD determines whether any of the lenders' principal officers are ineligible to participate in FHA's programs because of outstanding federal debts; because of recent bankruptcies or derogatory credit; or because they have been suspended, debarred, or otherwise excluded from the department's programs and activities. Lenders must be annually recertified by HUD to maintain their FHA-approved status.

As of August 2004, over 10,000 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes. Most FHA-approved lenders are authorized to originate FHA-insured loans,

[7]Capital reserves are the amount of capital reserved to cover estimated future losses resulting from the payment of claims on defaulted mortgages and administrative costs.

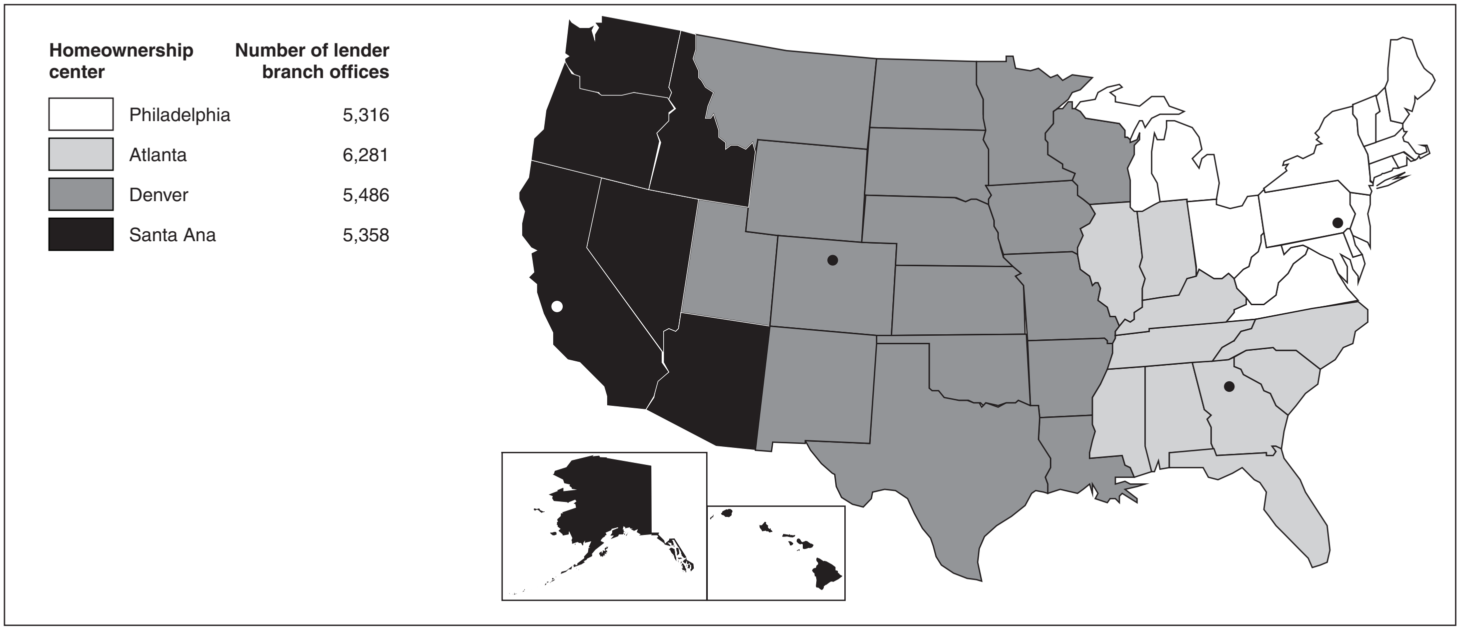
meaning that they can accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process. Approximately 2,900 of the FHA-approved lending institutions also have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review.[8] Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan. Virtually all FHA-insured mortgages for single-family homes are underwritten by lenders with direct endorsement authority.

Some FHA-approved lenders with direct endorsement authority, known as sponsoring lenders, enter into agreements to underwrite and fund loans originated by other FHA lenders who do not have direct endorsement authority, known as loan correspondents. About 71 percent of FHA's approved lenders are loan correspondents, meaning that they originate FHA-insured mortgages and sell or transfer the loan paperwork to sponsoring lenders for underwriting and approval. According to HUD's regulations, sponsoring lenders are responsible for the loan origination activities of their loan correspondents.

HUD's 2020 Management Reform Plan, which was announced in 1997, consolidated the single-family mortgage housing activities of HUD's 81 field offices into four homeownership centers, each of which is responsible for a multistate area. (See fig. 2.) The homeownership centers are located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California; and report directly to the Deputy Assistant Secretary for Single Family Housing in HUD's Washington, D.C., headquarters.

[8]To be eligible to receive direct endorsement authority and to underwrite FHA-insured loans, a lender, in addition to meeting other HUD requirements, must be one of the following: (1) 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; (2) a financial institution whose principal activity is lending or the investing of funds in real estate mortgages; or (3) a federal, state, or municipal government agency.

Figure 2: Geographical Jurisdictions of HUD's Four Homeownership Centers and Lender Branches in Each Jurisdiction



Source: GAO analysis of HUD data.

The homeownership centers are responsible for processing and approving mortgage insurance, as well as implementing several critical aspects of HUD's lender approval, monitoring, and enforcement activities. These responsibilities include (1) evaluating, through a process known as preclosing reviews, loans submitted by FHA-approved lenders seeking direct endorsement authority and granting direct endorsement authority to qualified lenders; (2) evaluating lenders' operations, through a process known as lender reviews, and monitoring lenders' performance through reviews of individual loans, known as technical reviews; and (3) taking enforcement actions against lenders that have not complied with FHA's requirements. HUD's headquarters also has important approval, monitoring, and enforcement functions. For example, HUD's headquarters is responsible for annually recertifying lenders that wish to participate in FHA's mortgage programs. HUD's Credit Watch program, an initiative to identify and impose sanctions against lenders with unacceptably high rates of defaults and insurance claims on FHA-insured mortgages, is managed by HUD's Office of Lender Activities and Program Compliance. HUD's Mortgagee Review Board, an enforcement body chaired by HUD's Assistant Secretary for Housing-Federal Housing Commissioner, can impose administrative sanctions against lenders, including withdrawing the lenders' authority to make FHA-insured loans.[9]

In April 2000, we reported on HUD's lender approval, monitoring, and enforcement efforts. Among other things, we noted that HUD's guidance for granting direct endorsement authority was not clear, which led the homeownership centers to interpret it differently. We also reported that HUD's monitoring did not focus on the lenders and loans that posed the greatest insurance risks to the department. In addition, we observed that the homeownership centers were making only limited use of their ability to suspend lenders' direct endorsement authority and that HUD's Credit Watch program pertained only to the lenders that originated troubled loans.

Homeownership Centers Have Not Consistently Followed HUD's Guidance for Granting Direct Endorsement Authority

HUD's homeownership centers, which are responsible for granting direct endorsement authority to lenders participating in FHA's programs, have not consistently followed HUD's guidance for granting this authority. According to departmental guidance, FHA-approved lenders seeking direct endorsement authority must go through a probationary period and are required to demonstrate "acceptable performance" in underwriting at least 15 mortgage loans. During this probationary period, the lenders send to the homeownership centers mortgage loans that have not yet been "closed"—that is, the borrower has not yet taken on the loan obligation. The homeownership centers then evaluate the loans against FHA's underwriting requirements.[10] During these evaluations, known as preclosing reviews, the homeownership centers rate the quality of the construction exhibits (for new or rehabilitated homes), the valuation of the mortgaged property, and the mortgage credit evaluation of the borrower as "good," "fair," or "poor."[11] (See fig. 3.) According to HUD guidance, a "good" rating indicates no underwriting deficiencies, a "fair" rating indicates the presence of deficiencies that would not affect the insurance eligibility determination,

[9]The other members of the Board are HUD's General Counsel, Chief Financial Officer, Assistant Secretary for Administration, Assistant Secretary for Fair Housing and Equal Opportunity, and Director of the Enforcement Center; and the President of the Government National Mortgage Association.

[10]At the Atlanta, Denver, and Philadelphia homeownership centers, staff perform these evaluations. In contrast, a contractor performs these evaluations for the Santa Ana homeownership center.

[11]During a preclosing review, the Denver homeownership center also sometimes evaluates the quality of the loan-closing documents.

and a “poor” rating indicates underwriting errors that would significantly increase HUD’s insurance risk. HUD’s guidance provides specific criteria for the homeownership centers to use in determining these ratings.

Figure 3: Preclosing Review Loan Rating Categories and Scoring System

Category	Loan 1	Loan 2	Loan 3
Architecture and engineering • Required new construction exhibits • Inspections	N/A	N/A	○
Valuation • Appraisal package • Sales comparison • Neighborhood/site • Description of improvements	○	○	◍
Mortgage credit • Income • Assets • Liabilities • Credit	○	◍	●
Overall	○	◍	●

○ Good
◍ Fair
● Poor

Source: GAO.

Note: “N/A” means not applicable. The three loan examples are provided for illustration only. The overall rating is equal to the lowest rating assigned to an individual rated category. For example, if one category is rated “poor,” the overall rating for that loan is a “poor.”

In our April 2000 report, we noted that HUD’s guidance for granting direct endorsement authority was unclear because it did not define what would constitute overall acceptable performance. As a result, we found that the homeownership centers had implemented the existing guidance differently and had approved lenders that demonstrated varying levels of proficiency, including lenders that had made multiple and serious underwriting mistakes. In response to our report, HUD issued its current guidance for granting FHA-approved lenders direct endorsement authority in September 2002. The guidance states that, in order to qualify for direct endorsement authority, a lender must submit a minimum of 15 mortgage loans that receive ratings of “good” or “fair” within a year, with the last 5 consecutive loans rated “good” or “fair.” These 15 mortgages may include loans for home purchase transactions (including 203(k) loans) and full credit-qualifying refinances.[12] Only 5 of the 15 required mortgages may be from a combination of automated underwriting, streamline refinances, and fully underwritten loans denied by other lenders.[13] In addition, a lender cannot submit more than 30 mortgage loans for HUD's review during this probationary period. The guidance states that, if the lender has submitted 30 loans and has not met the standards to be granted direct endorsement authority, the lender must be notified that it cannot submit mortgage loans for at least 6 months.

Although HUD has issued specific guidance, the homeownership centers have not consistently followed it. To determine how well each homeownership center followed HUD's guidance, we analyzed preclosing review ratings given to the loans submitted by all 49 lenders that entered the probationary period on or after October 1, 2002, (after the guidance was implemented) and were granted direct endorsement authority by April 30, 2004.[14] (Approximately 290 other lenders were in the process of seeking, but had not yet received, direct endorsement authority as of April 30, 2004.) The 49 lenders submitted an average of 24 loans to the homeownership centers for preclosing reviews.

[12]Under the 203(k) Home Rehabilitation Mortgage Insurance program, a borrower can get one mortgage loan to finance both the acquisition and rehabilitation of the property. A refinance transaction involves repaying an existing real estate debt from the proceeds of a new mortgage that has the same borrower and the same property.

[13]When automated underwriting is used, a computer-based tool simplifies the processing of loan applications by analyzing, among other things, how a borrower managed credit obligations in the past and whether the borrower has the ability to repay the mortgage loan. It then provides a recommendation to the lender to approve the loan or refer it for manual underwriting. A streamline refinance is a type of refinance transaction that requires less paperwork. For example, streamline refinances can be made without an appraisal, and HUD does not require a credit report.

[14]One additional lender with direct endorsement authority applied for and was granted the authority to underwrite Home Equity Conversion Mortgages (HECM)—mortgages that can be used by senior homeowners to convert equity into income—during this time period. HUD's guidance states that, after receiving direct endorsement approval, lenders may apply for approval to underwrite specialized loans such as HECM and 203(k) loans by submitting a minimum of five consecutive cases of that type rated "good" or "fair." According to our analysis, the lender submitted a minimum of five consecutive HECM cases rated "good" or "fair."

Our analysis showed that the homeownership centers granted some of the 49 lenders direct endorsement authority in violation of HUD's criteria. Specifically, we found the following:

- Seven of the lenders did not submit at least 15 mortgage loans that were rated "good" or "fair."
- Two lenders were granted direct endorsement authority although the last 5 consecutive loans they submitted were not rated "good" or "fair."[15]
- One lender exceeded the allowed 1-year probationary period, and eight lenders submitted more than the 30 loans allowed before being granted direct endorsement authority. The number of mortgage loans submitted by these lenders ranged from 31 to 73.

Our analysis of the loans submitted by the 49 lenders was based on information contained in a log maintained for each lender seeking direct endorsement authority. According to homeownership center officials, they use this log to determine if a lender has met HUD's standards. When commenting on the results of our analysis, HUD officials stated that some of the information in the logs we reviewed was incorrect. For example, they noted that some of the loans were incorrectly entered as automated underwriting cases. Because the information in the log is what the homeownership center officials use to determine if the standards have been met, we did not change our findings based on the new information provided by HUD. HUD officials also noted that they had sometimes used management discretion when applying the standards. For example, for one case in which we determined that the last five consecutive cases were not rated "good" or "fair," the homeownership center staff determined that, despite the one loan rated "poor" out of the last five, the lender had submitted a sufficient number of loans rated "good" or "fair" to be approved.

[15]In three additional cases, the lender continued submitting loans after it had satisfied HUD's requirements of having a total of 15 loans rated "good" or "fair," with the last 5 of the 15 loans rated "good" or "fair." One of the extra loans submitted was rated "poor," which meant that the last five consecutive cases submitted by the lender were not rated "good" or "fair."

HUD's Monitoring Is Risk-Based, but Certain Factors Limit the Usefulness of Its Monitoring Tools

Although HUD has adopted a risk-based approach to monitoring lenders, certain factors limit the usefulness of the tools it employs. The homeownership centers rely on two primary monitoring tools to ensure lenders' compliance with FHA's mortgage requirements: (1) lender reviews, which are generally on-site evaluations of lenders' operations, performed by HUD staff and (2) technical reviews, which are desk audits of the underwriting quality of individual loans already insured by FHA, performed mainly by contractors. Since May 2000, the homeownership centers have generally been targeting for review those lenders they consider to be high risk, but HUD's reports do not distinguish between on-site and desk reviews. HUD has started selecting loans for technical reviews based on characteristics associated with risk and done a better job of tracking the performance of the contractors that perform most of HUD's technical reviews. However, its technical review rating system does not currently reflect the different levels of risk that underwriting errors pose to the insurance fund.

Although HUD Is Following Its Guidance in Targeting High-Risk Lenders, Its Reports Do Not Identify Desk Reviews

Since May 2000, the homeownership centers have targeted lenders for review based on indicators of risk, and our analysis shows that they have generally reviewed the lenders that they have identified as high-risk lenders. Although on-site reviews are the preferred method of monitoring, HUD's reports do not identify the number of desk reviews performed.

Most Lenders Reviewed Were Targeted Based on Risk

Lender reviews typically involve an in-depth analysis of a sample of loans and assessments of lenders' internal control systems for making loans. If a lender review finds serious deficiencies with specific loans or the lender's internal controls, HUD may take actions that reduce the department's insurance risk, such as requiring the lender to compensate HUD for financial losses that HUD has incurred or may incur on certain loans. Staff assigned to each homeownership center's quality assurance division are responsible for scheduling and performing these reviews. In fiscal year 2003, HUD's homeownership centers conducted 910 lender reviews, exceeding the department's goal of 900 reviews.

In April 2000, we reported that, contrary to HUD's guidance, the homeownership centers were not always reviewing the lenders that they considered to pose the highest risks and concluded that HUD lacked a systematic process for identifying and prioritizing such lenders for review. In response, HUD issued a May 2000 memo calling for the homeownership centers to target lenders for lender reviews based on indicators of risk. Because early defaults and claims—loans reported as 90 days or more delinquent and loans terminated by claim within the first 24 months of origination—are an indicator of poor lending practices that may ultimately result in insurance losses, HUD considers them to be the primary risk factors in targeting lenders for review. Thus, each quarter the homeownership centers use data from HUD's Neighborhood Watch Early Warning System (Neighborhood Watch)—an information system that displays loan performance data by loan types and geographic areas—to identify the lenders that pose the highest risk to the insurance fund in terms of defaults and claims.[16] In addition, the guidance lists other factors to be considered when targeting lenders, including the length of time since their last review, complaints or reports of irregularities or fraudulent activity in a lender's practices, and the results of HUD's technical reviews of individual lenders' loans. (See fig. 4.) According to HUD, the target reports developed each quarter to identify the lenders to be reviewed are "fluid;" for example, changes may result if there is a large number of complaints about a particular lender.

Figure 4: Steps to Be Taken Each Quarter to Target Lenders for Lender Reviews

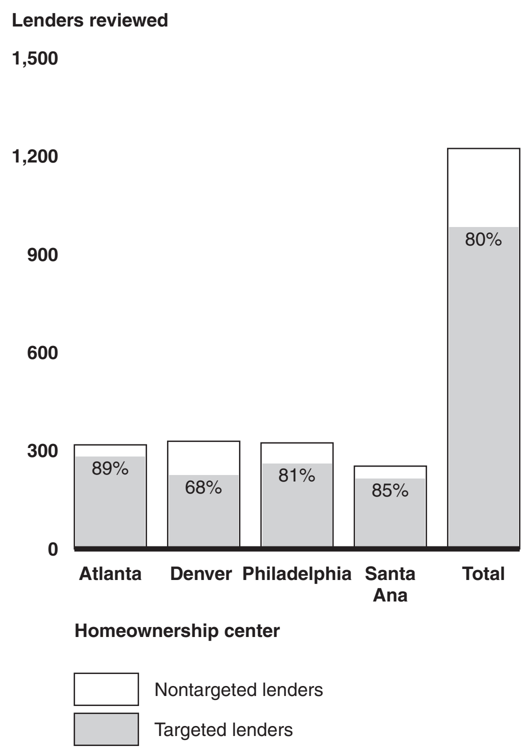
Source: GAO analysis of HUD guidance.

Note: Other factors that the homeownership centers are to consider during the targeting process include high-risk programs such as the 203(k) program and sudden increases in business volume.

[16]The loan information in Neighborhood Watch is displayed for a 2-year origination period and is updated monthly.

We found that HUD's homeownership centers are generally following this guidance when targeting lenders for reviews. All four homeownership centers provided us with lists of the lenders they targeted for review in fiscal year 2003 and the first two quarters of fiscal year 2004 and the lenders they reviewed during the same time period. Overall, our analysis of these lists showed that about 80 percent of the lenders reviewed by the four homeownership centers during these six quarters were lenders on their target lists. As shown in figure 5, the percentage of lenders reviewed by each homeownership center that were on their target lists ranged from 68 percent in Denver to 89 percent in Atlanta.

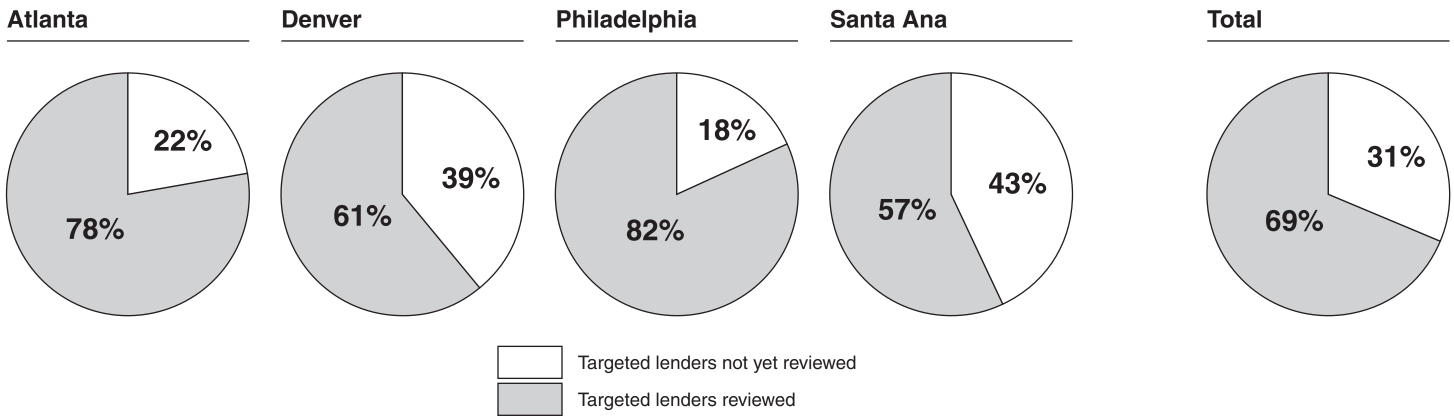
Figure 5: Extent to Which Lenders Reviewed by Homeownership Centers Were Targeted Lenders, Fiscal Year 2003 and First Two Quarters of Fiscal Year 2004



Source: GAO analysis of data provided by HUD's four homeownership centers.

Furthermore, about 69 percent of the lenders that were targeted by the homeownership centers had been reviewed by the end of the six quarters. As shown in figure 6, the percentage of lenders that were targeted and reviewed ranged from 57 percent for Santa Ana to 82 percent for Philadelphia. According to HUD, reviews not completed during the quarter are carried over to the subsequent quarter and nearly all are completed.

Figure 6: Extent to Which Lenders Targeted by Homeownership Centers Were Reviewed, Fiscal Year 2003 and First Two Quarters of Fiscal Year 2004



Source: GAO analysis of data provided by HUD's four homeownership centers.

HUD is seeking to improve its risk-based monitoring of lenders. According to HUD officials, the department has hired a contractor to help it analyze all collected FHA loan data to determine if more of it can be used to target lenders for review. According to the statement of work, the contractor is to design, among other things, a risk-based model using HUD data that will identify lenders that pose a risk to the FHA insurance fund.[17] In developing this model, the contractor is to (1) analyze risk-based models used by Fannie Mae, Freddie Mac, and private mortgage insurers to determine how these entities evaluate the risk related to single-family loans; (2) analyze the data available in HUD's data systems that can be used to develop risk-based model(s); and (3) recommend additional data not already available

[17]The risk-based model that is to be developed by the contractor must be adaptable and compatible with HUD's Neighborhood Watch System. The lender information that may be used in developing the model includes, among other things, the percentage of originations with late up-front mortgage insurance premiums, the percentage of signed indemnification agreements (which require the lender to compensate HUD for financial losses that HUD has incurred or may incur on certain loans), and high default and claim rates.

in HUD's systems that should be used in the development of a risk-based model.[18]

Reports Did Not Distinguish Between On-Site and Desk Reviews

According to HUD's guidance on conducting lender reviews, a desk review may be acceptable for a focused review—a review of a specific operational area, specific loan type, or specific issue—and necessary when travel funds are constrained. Even so, both HUD and homeownership center officials acknowledge that on-site reviews are the preferred method of monitoring lenders' operations. General HUD guidance on monitoring states that on-site monitoring reviews are essential for high-risk programs. In addition, its guidance on conducting lender reviews lists certain factors that should be considered, including determining if the lender's office facilities meet HUD's requirements. For example, when conducting an on-site review a reviewer should, among other things, observe whether the public can properly identify the lender. Homeownership center officials also note that on-site reviews are preferable because they can request additional loans to review on short notice and they sometimes get leads from employees who want to disclose problems. On-site reviews also give HUD an opportunity to provide technical assistance to the lenders.

All four homeownership centers are performing some off-site lender reviews (i.e., desk reviews); however, their reports do not identify the number of desk reviews performed. At our request, homeownership center officials conducted a manual search of their records and determined that 70 of the 910 lender reviews performed in fiscal year 2003 (about 8 percent) were desk reviews. Although all four homeownership centers performed at least some desk reviews, HUD's Office of Lender Activities and Program Compliance, the headquarters office that oversees lender reviews, described all of the reviews that the homeownership centers performed in fiscal year 2003 as on-site reviews in its annual report.

[18]Both Fannie Mae and Freddie Mac are federally-chartered corporations that purchase residential mortgages and convert them into securities for sale to investors; by purchasing mortgages, they supply funds that lenders may loan to potential homebuyers.

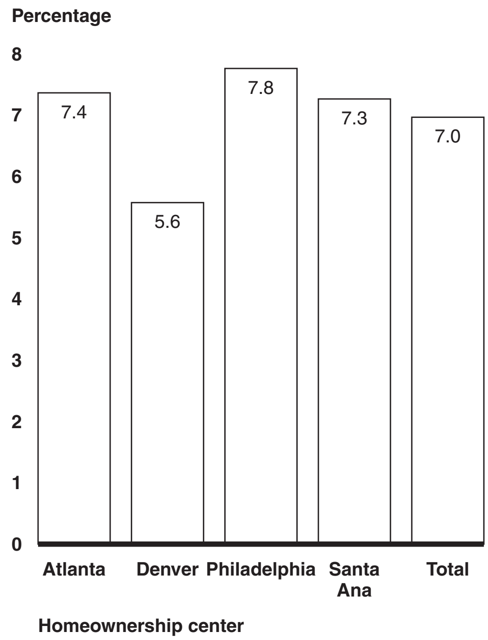
HUD Now Selects Loans for Technical Reviews Based on Risk and Better Oversees Contractors, but Its Reviews Serve a Limited Purpose

In response to recommendations in our April 2000 report, HUD has started selecting loans for technical reviews based on loan risk characteristics and improved its oversight of the contractors that perform technical reviews. However, technical reviews serve a limited purpose because the system used to rate lender performance on individual loans does not identify the underwriting errors that pose the greatest risk, and the reviews do not help HUD identify (1) loans that have a high probability of default or claim or (2) loans susceptible to fraud.

Selection Is Generally Based on Loan Risk Characteristics

Technical reviews are desk audits that evaluate the underwriting quality of individual loans already insured by FHA. They are similar to preclosing reviews in that HUD evaluates the quality of the construction exhibits (for new or rehabilitated homes), the valuation of the mortgaged property, the mortgage credit evaluation of the borrower, and the loan-closing documents and assigns a “good,” “fair,” or “poor” rating in each applicable category. Reviews revealing serious deficiencies may result in, among other things, HUD’s requiring the lenders to compensate the department for financial losses or HUD’s suspending the lenders’ direct endorsement authority. In total, the four homeownership centers performed 133,446 technical reviews in fiscal year 2003 and the first two quarters of fiscal year 2004, representing 7 percent of the loans that FHA insured during that time period (see fig. 7).

Figure 7: Percentage of Loans Receiving Technical Reviews, Fiscal Year 2003 and First Two Quarters of Fiscal Year 2004



Source: GAO analysis of HUD data.

Prior to February 2004, HUD used the Computerized Homes Underwriting Management System (CHUMS)—a computer system that assists and supports HUD staff in processing mortgage insurance for single-family homes—to randomly select a certain percentage of each lender's loans for technical reviews. However, as we noted in our April 2000 report, HUD's guidance recommends that the loans selected for technical reviews should be those that pose a high risk of loss to the insurance fund. In February 2004, HUD implemented a CHUMS algorithm that provides a risk-based statistical process for selecting loans for review at time of approval. The algorithm selects loans for review based on certain characteristics—such as loans made to first-time homebuyers, loans with adjustable rate mortgages, and loans for multiple housing units. According to HUD officials, loans that exhibit these high-risk characteristics are, all other things being equal, more likely to be subject to default and/or contain underwriting errors than loans that do not.

Homeownership center staff also have the ability to adjust, in CHUMS, the percentage of a lender's loans selected for technical reviews to more closely monitor certain lenders. For example, HUD's guidance states that the homeownership centers should perform technical reviews of 100 percent of at least the first 30 FHA-insured loans made by newly approved direct endorsement lenders. However, our analysis of loans made by the 49 lenders that entered the probationary period on or after October 1, 2002, and were granted direct endorsement authority by April 30, 2004, shows that the homeownership centers have not followed this guidance. As of June 2004, only 16 of these lenders had used their direct endorsement authority to make loans. Contrary to HUD guidance, the homeownership centers had reviewed only about 7 percent of these lenders' early loans. According to homeownership center officials, they do not always select the first 30 loans to review because some of the lender's early loans may have been made by a new branch office of which they are unaware.[19] Also, CHUMS does not automatically maintain the 100 percent designation used to flag a new lender's early loans for review. As part of an effort to control the volume of technical reviews, CHUMS revises some of the review percentages each quarter. As a result, the 100 percent designation for newly authorized lenders is sometimes changed to less than 100 percent, causing the homeownership centers to miss some of these lenders' loans.

Tracking of Technical Review Contractors' Performance Has Improved in Recent Years

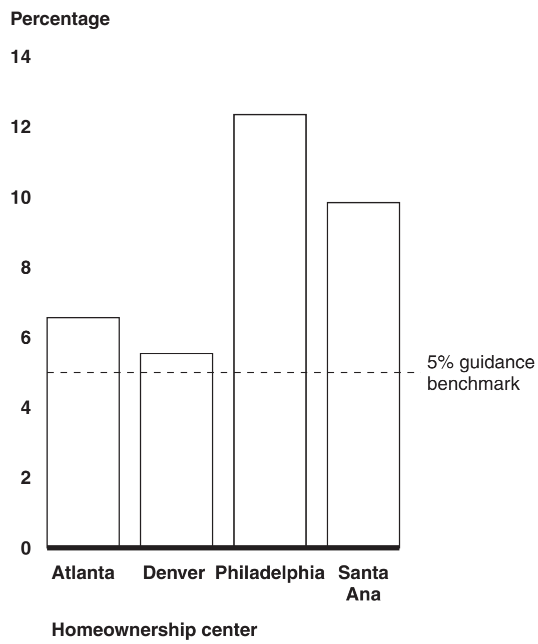
The large majority of HUD's technical reviews are performed by firms under contract with the homeownership centers, and HUD has done a better job of tracking these contractors' performance in recent years.[20] In our April 2000 report, we noted that the technical review contracts in place at the time contained specific performance standards expressed as the maximum acceptable percentage of reviews that could contain significant errors or omissions. However, we found that three of the four homeownership centers were not tracking the contractors' work against these standards. As a result, these homeownership centers lacked the information necessary to evaluate the quality of the contractors' work or to determine whether actions should be taken against the contractors for poor performance.

[19]Direct endorsement authority is granted to a lender's home office and applies to all of the lender's branch offices.

[20]Virtually all of the Atlanta, Philadelphia, and Santa Ana homeownership centers' technical reviews are performed by contractors. In contrast, Denver homeownership center staff performed 44 percent of the homeownership center's reviews in fiscal year 2003. At the time of our study, the Santa Ana homeownership center had two firms under contract, while the Atlanta, Denver, and Philadelphia homeownership centers each used a single contractor.

The four homeownership centers are currently evaluating the quality of their contractors' work. Each homeownership center's technical review contract states that the contractor must deliver 90 percent of the completed reviews without any errors. An error is defined as any instance in which HUD has to change a "poor" rating to a "good" or "fair" rating or when it has to change a "fair" or "good" rating to a "poor" rating. To determine if the contractor is meeting this standard, the contracts require HUD to randomly select and evaluate a minimum of 5 percent of the contractor's completed reviews. If the contractor's error rate exceeds 10 percent for the review period, HUD's payment will be reduced by 1 percent for each error percentage point above 10 percent. As shown in figure 8, the homeownership centers reviewed at least 5 percent of their contractors' work in fiscal year 2003.

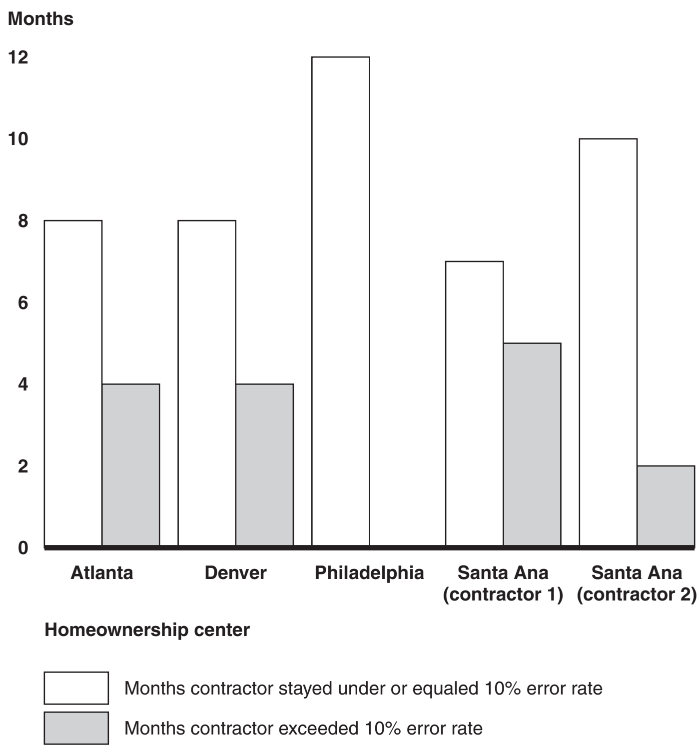
Figure 8: Percentage of Technical Review Contractors' Work Reviewed by Homeownership Centers in Fiscal Year 2003



Source: GAO analysis of data provided by HUD's four homeownership centers.

The homeownership centers have used the results of their quality assurance reviews to track their contractors' performance. For each month in fiscal year 2003, the four homeownership centers calculated their contractors' error rate (a total of 60 calculated error rates because Santa Ana uses two contractors). As a result, they were able to track whether their contractors exceeded the allowed error rate of 10 percent. As shown in figure 9, three of the four centers identified that their contractors had exceeded the allowed error rate.

Figure 9: Technical Review Contractors' Fiscal Year 2003 Performance



Source: GAO analysis of data provided by HUD's four homeownership centers.

Despite better tracking, the homeownership centers were not always able to hold their contractors accountable for unacceptable performance. Only the Santa Ana center could provide us with support that it assessed contractors a penalty when appropriate in fiscal year 2003. According to an Atlanta center official, they did not assess a disincentive to the contractor in fiscal year 2003 when its error rate exceeded 10 percent because they did not complete their quality assurance reviews within 30 days. The official also stated that they had solved the timing problem as of October 2003 and that all reviews are currently completed within the 30-day requirement in order to properly assess disincentives. Similarly, a Denver center official stated that the center did not assess any disincentives because system problems made it difficult to calculate the error rates correctly. The center has since corrected the problem, according to the same official. The Philadelphia center's contractor did not exceed the allowed error rate in fiscal year 2003.

Technical Reviews Serve Limited Purpose

Homeownership center staff have questioned the usefulness of technical reviews because the rating system does not identify the underwriting errors that pose the greatest risk to the insurance fund. According to homeownership center officials, the current rating system results in too many "poor" ratings being assigned. To determine the percentage of "poor" ratings assigned, we requested data from all four homeownership centers for fiscal year 2003 and the first two quarters of fiscal year 2004. As shown in figure 10, the percentage of "poor" ratings was over 50 percent for at least one category at three of the four homeownership centers. At each homeownership center, the highest percentage of "poor" ratings was in mortgage credit. Overall, 70 percent of the loans that were rated in the mortgage credit category received "poor" ratings.

Figure 10: Percentage of "Poor" Ratings Assigned during Technical Reviews Performed in Fiscal Year 2003 and First Two Quarters of Fiscal Year 2004, by Category

	Percentage of "poor" ratings				
Category	Atlanta	Denver	Philadelphia	Santa Ana	All four centers
Architecture and engineering	60%	17%	45%	33%	43%
Valuation	51	14	42	39	39
Mortgage credit	76	38	73	92	70
Closing	29	26	27	80	37

Source: GAO analysis of Underwriting Reports System data provided by HUD's four homeownership centers.

Note: Not all loans are evaluated in all four categories. For example, only loans for new or rehabilitated homes receive an architecture and engineering rating.

Although HUD guidance states that a “poor” rating indicates underwriting errors that significantly increased HUD’s insurance risk, homeownership center officials said that the current system does not distinguish between a “poor” rating that represents a compliance or documentation issue and a “poor” rating that represents a risk to the insurance fund. Our analysis of the most common deficiencies cited during technical reviews performed in fiscal year 2003 and the first two quarters of fiscal year 2004 shows that the majority of them are compliance issues. As shown in figure 11, the most common deficiencies cited often involve problems with paperwork. According to homeownership center officials, only 3 of the 10 deficiencies that we identified as the most common represent a risk to the FHA insurance fund.

Figure 11: Deficiencies Most Commonly Cited during Technical Reviews Performed in Fiscal Year 2003 and First Two Quarters of Fiscal Year 2004

Deficiency	Number of loans where deficiency was cited
Unacceptable or excessive charges to the borrower	30,274
Credit Alert Interactive Voice Response System or Limited Denial of Participation/General Services Administration checks not completed[a]	17,754
"For Your Protection: Get a Home Inspection" form not dated or signed[b]	16,256
Homebuyer summary form not signed by the purchaser(s) 5 business days prior to closing[c]	13,427
Missing real estate certification/escape clause	12,289
Data input into automated underwriting system does not match documentation in file	11,239
Poor credit (such as a foreclosure or pattern of slow payments) not satisfactorily explained	10,008
Repair inspections/certification by professional trades person or approvals by local authorities missing (e.g., termite clearance, roofing, individual water and sewer systems)	9,778
Automated underwriting system requirements not provided in file or ineligible for documentation waiver	7,420
Lender or seller paid items or credits to the borrower not identified or individually enumerated on HUD-1[d]	6,019

Compliance issue

Risk issue

Source: GAO analysis of Underwriting Reports System data provided by HUD's four homeownership centers.

Note: These were the most commonly cited deficiencies that must result in a "poor" rating. For some deficiencies, the reviewer has the discretion to decide, based on the severity of the deficiency, whether the rating should be "fair" or "poor."

[a]The Credit Alert Interactive Voice Response System is a federal government database of delinquent federal debtors maintained to prescreen direct loan applicants for creditworthiness. HUD maintains a list of parties who have been issued a limited denial of participation—an action that excludes a party from further participation in a HUD program area. The General Services Administration maintains a list of parties excluded from receiving (1) federal contracts or certain subcontracts and (2) certain types of federal financial and nonfinancial assistance and benefits.

[b]The “For Your Protection: Get a Home Inspection” form stresses the importance of obtaining a home inspection prior to purchase.

[c]The purpose of the homebuyer summary form is to provide timely information to the buyer for repairs to be completed or property conditions that have to be satisfied prior to FHA insurance endorsement.

[d]The HUD-1 form, also called the Settlement Statement, records the money flows that take place when the ownership of a home is transferred from a seller to a buyer.

HUD’s financial statement auditors have also questioned the usefulness of technical reviews. In the audit of FHA’s financial statements for fiscal years 2002 and 2003, the independent auditors noted that technical reviews, as currently designed, assisted the homeownership centers in reporting documentation and processing errors back to the lenders but did not help them identify loans that have a high probability of default or claim as a result of poor lender underwriting practices.[21] When the auditors analyzed data on the 2,000 lenders with the highest volume of originations, they found no strong correlation between the percentage of technical review “poor” ratings received by a lender and the lender’s early default and claims rates. As a result, the auditors recommended that HUD consider redesigning the technical review process as an early warning control that better predicts loan performance so that it could be used not only as a lender monitoring tool but also as an effective tool to assist FHA in identifying lenders that originate loans that have a high probability of going to default or claim.

HUD officials acknowledged that technical reviews were not designed to help HUD identify loans that have a high probability of default or claim or loans susceptible to fraud; instead, they were designed to evaluate the quality of the lender’s underwriting. The department has taken several steps to make technical reviews more meaningful, according to HUD officials. First, HUD has converted the Underwriting Reports System—the system used to track the results of technical reviews—to a web-based system, which will allow it to perform more analysis of the technical review ratings. Second, HUD plans to revise the deficiency codes used to assign technical review ratings. Currently, there are over 250 codes for mortgage credit and valuation issues. The homeownership centers have proposed reducing that number substantially and replacing the “poor” rating with a “risk issues” rating—reserved for those deficiencies that affect the

[21]To complete the FHA audit, HUD’s Inspector General contracted with the independent certified public accounting firm of KPMG LLP. U.S. Department of Housing and Urban Development, Office of Inspector General, *Audit of the Federal Housing Administration’s Financial Statements for Fiscal Years 2003 and 2002*, 2004-FO-0001 (Washington, D.C.: Nov. 25, 2003).

eligibility of the loan—and the “fair” rating with a “compliance issues” rating, given for those errors that do not affect eligibility.

Efforts to Hold Lenders Accountable for Poor Performance Have Not Been Comprehensive

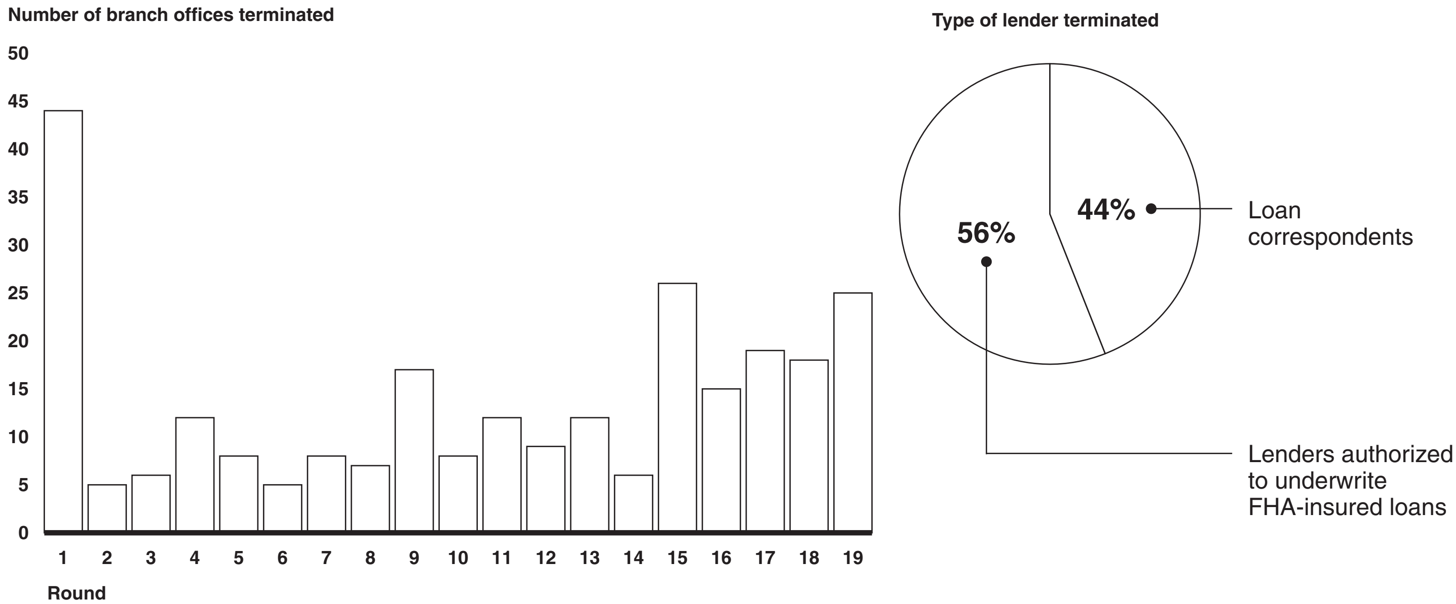
To hold lenders accountable for poor performance, HUD may (1) terminate their loan origination authority through its Credit Watch program, (2) suspend their direct endorsement authority, or (3) take enforcement action through its Mortgagee Review Board. HUD has terminated the loan origination authority of 262 lender branch offices and has recently proposed changes to make its Credit Watch program more effective as a means of sanctioning lenders responsible for high rates of defaults and insurance claims. However, the homeownership centers have rarely used their ability to suspend direct endorsement authority. Further, HUD’s Mortgagee Review Board sometimes takes a year or more to take action against lenders for program violations, during which time the lender can continue to make dozens of loans.

HUD Has Proposed Credit Watch Changes to Improve Program’s Effectiveness

HUD has recently proposed changes to improve the effectiveness of its Credit Watch program. In May 1999, HUD announced that it would begin to use its Credit Watch program to sanction lenders with excessively high loan default and claim rates. Initially, HUD planned on a quarterly basis to (1) terminate the loan origination authority of any lender branch office whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeded both the national average and 300 percent of the average rate for the HUD field office serving the lender’s geographic location (field office rate) and (2) place on Credit Watch status the branch offices whose default and claim rates exceeded 200 percent of the average field office rate. While on Credit Watch status, the branch could continue to originate FHA-insured loans, but HUD would review the insured loans that the branch originated during a 6-month period from the date the Credit Watch status became effective for excessive default rates. In October 2001, HUD announced that it was eliminating the placement of lenders on Credit Watch status because advanced warning of excessive default and claim rates was no longer necessary since the department had provided lenders with access to their performance via Neighborhood Watch. Also, in September 2002, HUD stated that it would be gradually reducing the 300 percent termination threshold set for the HUD field office rate to the 200 percent allowed in HUD’s regulations.

As of July 2004, HUD had conducted 19 rounds under its Credit Watch initiative, with the last round being based on analysis of the 24-month period ending December 31, 2003.[22] This program has resulted in the department's termination of 262 branch offices' loan origination authority.[23] As shown in figure 12, the number of branch offices that were terminated as a result of each round has varied.

Figure 12: Results of the First 19 Rounds of HUD's Credit Watch Program



Source: GAO analysis of HUD data.

Currently, the regulations governing HUD's Credit Watch program only allow the department to hold the lenders that originated the troubled loans accountable for excessive defaults or insurance claims. The regulations do not address HUD's authority to also hold accountable those lenders that have underwritten the loans. When originating mortgage loans, lenders

[22]Every quarter, HUD conducts a round of Credit Watch by reviewing the rate of defaults and claims on loans insured by FHA within the preceding 24-month period.

[23]A terminated lender branch may request to have its authority to originate FHA loans reinstated no earlier than 6 months after the effective date of the termination.

perform such functions as accepting mortgage applications and obtaining employment verifications and credit reports on the borrowers. When underwriting mortgage loans, lenders use this information to determine whether borrowers are able to make their mortgage payments and whether the loans should be approved. As shown in figure 12, 44 percent of the lenders terminated during the first 19 rounds of Credit Watch were loan correspondents—lenders that sell or transfer loans that they originate to other FHA lenders, known as sponsoring lenders, for underwriting and approval.

In response to a recommendation in our April 2000 report, HUD has published a proposed rule making several amendments to the Credit Watch program, including holding underwriting lenders accountable for excessive default and claim rates.[24] The proposed rule, issued in April 2003, includes several changes designed to strengthen HUD's capacity to safeguard the FHA mortgage insurance fund. Specifically, it proposes, among other things, applying the default and claim threshold to both originating and underwriting lenders and prohibiting a lender from opening a new branch office in the same lending area as an existing branch that has received a notice of proposed termination. The proposed rule was open for comments through June 2, 2003, and HUD submitted an interim rule to the Office of Management and Budget in July 2004.

Homeownership Centers Rarely Used Their Ability to Suspend Lenders' Direct Endorsement Authority

HUD's homeownership centers have made limited use of their ability to suspend the direct endorsement authority of lenders that fail to comply with FHA's program requirements. Lenders whose direct endorsement authority is suspended but who wish to continue underwriting mortgages insured by FHA must submit each proposed mortgage case file to a homeownership center, which evaluates the lenders' underwriting decisions before deciding whether to insure the loans. The lenders must follow this procedure until HUD's evaluations of the case files indicate that the lenders have demonstrated satisfactory performance in underwriting loans.

HUD's guidance allows the homeownership centers to suspend direct endorsement authority but does not prescribe the circumstances under

[24]In our April 2000 report, we recommended that HUD revise the Credit Watch program's regulations to cover lenders that underwrite FHA-insured loans with excessive default and claim rates, as well as those lenders that originate such loans.

which the homeownership centers must do so. HUD's handbook on the direct endorsement program provides general guidelines. For example, the guidance states that the homeownership centers should consider suspending lenders that exhibit "patterns" of noncompliance, but it does not define what would constitute a pattern. After our April 2000 report recommended that HUD clarify and implement guidelines for identifying lenders whose direct endorsement authority should be suspended, the department issued supplemental guidance in a November 2000 memo. The memo describes certain conditions under which the homeownership centers may suspend direct endorsement authority.[25]

Among the four homeownership centers, we found that the Philadelphia homeownership center was the only one that suspended the direct endorsement authority of any lenders during fiscal year 2003 and the first two quarters of fiscal year 2004. Specifically:

- The Philadelphia homeownership center took this action against seven lenders during this time frame, citing underwriting violations identified during technical reviews and high default rates.[26]

- Although the Denver homeownership center did not suspend any lender's direct endorsement authority during the same time period, it had warned seven lenders that it might do so if they did not address underwriting deficiencies revealed in technical reviews.

- Rather than suspending a lender's direct endorsement authority, Atlanta homeownership center officials told us they will work with problem lenders to develop performance improvement plans. Such plans generally involve raising the percentage of a lender's loans that are selected for technical reviews, meeting with the lender to discuss its performance, and requiring the lender's staff to take training.

[25]These conditions include when a lender has maintained a "poor" percentage in excess of 20 percent for more than 90 days after being placed on 100 percent review status or when a lender has a claim and default rate that exceeds both the national rate and 250 percent of the field office rate (the rate for the HUD field office serving the lender's geographic location).

[26]The Philadelphia homeownership center first identifies lenders that (1) have a default rate that exceeds 150 percent of the field office rate and (2) have received technical review "poor" ratings over 20 percent (when more than 20 loans have been reviewed) and begins to review 100 percent of their loans. For lenders that do not improve after two quarters, the homeownership center suspends their direct endorsement authority.

- Similarly, Santa Ana homeownership center officials said that they tend to increase the percentage of a lender's loans that are selected for technical reviews instead of suspending direct endorsement authority.

HUD officials provided several reasons why they do not make more use of their ability to suspend direct endorsement authority. Officials at all four homeownership centers told us that suspending lenders would create an additional workload for them. Atlanta and Santa Ana officials also noted that suspending a lender's direct endorsement authority would threaten the lender's business. In addition, Denver officials observed that large lenders, when faced with suspension at one branch, would just send all their FHA loans to another branch. Finally, Santa Ana officials stated that, as long as the percentage of "poor" ratings assigned during technical reviews was so high, they did not want to rely on them as grounds for suspending direct endorsement authority. Headquarters officials noted that they want the homeownership centers to conduct lender reviews after problems are identified during technical reviews rather than immediately suspend lenders' direct endorsement authority.

Although HUD's homeownership centers suspended the direct endorsement authority of relatively few lenders in fiscal year 2003 and the first two quarters of fiscal year 2004, our analysis of HUD's technical review ratings for the same time period showed frequent noncompliance by lenders with FHA's requirements. About 7,800 lender branch offices received technical review ratings for mortgage credit analysis for the FHA-insured mortgages they underwrote.[27] Of these branch offices, we identified 1,203 that had at least 10 loans reviewed and received a "poor" rating for mortgage credit analysis—meaning that the lenders made mistakes in evaluating the borrowers' creditworthiness—on 75 percent or more of their reviewed loans. Even though the current rating system does not identify the underwriting errors that pose the greatest risks, this level of noncompliance indicates that more lenders may be candidates for enforcement action.

[27]Lenders could have been counted more than once if they underwrote FHA-insured mortgages in more than one homeownership center jurisdiction.

Mortgagee Review Board's Process for Sanctioning Lenders Is Time-Consuming

HUD's Mortgagee Review Board (Board) can impose administrative sanctions against FHA lenders that commit program violations, such as withdrawal of a lender's FHA approval. HUD does not have guidelines for the time it should take for the Board to take enforcement actions against lenders. We found the process can take over a year from the time the lender is notified of its violations to Board action.

The majority of the cases referred to the Board are the result of lending violations revealed in lender reviews performed by HUD's homeownership centers. Once the Board reviews and accepts a referral, it sends the lender a notice of violation that provides the lender 30 days to respond in writing to the Board. After reviewing the lender's response, the Board decides what actions to take. The Board may impose a number of sanctions against FHA-approved lenders, ranging from a letter of reprimand—a letter informing the lender of the existence or occurrence of a violation of HUD's requirement and directing the lender to bring and maintain its activities into conformity with all HUD requirements—to withdrawal of a lender's FHA approval. During the period of withdrawal (generally 3 to 5 years), HUD will not insure any mortgage originated by the withdrawn lender. Except for a letter of reprimand, the lender has a right to a hearing before the Board's sanction becomes final.

The majority of the Board's actions result in settlement agreements, which require lenders to indemnify improperly originated loans; pay fines; and/or take actions to prevent future lending violations. In June 2004, we reviewed the Board's records for the 32 cases involving single-family housing lenders that the Board had acted on in the previous 12 months.[28] We found that in 22 of the 32 cases, the Board had either reached a settlement agreement with the lender (20 cases) or was still attempting to reach a settlement agreement (2 cases).[29] In 8 of the cases, the Board had withdrawn the lenders' FHA approval. In the remaining 2 cases, the Board had either assessed a civil money penalty (1 case) or was still pursuing a civil money penalty (1 case).

[28]The 32 cases were acted on in Board meetings held in June 2003, August 2003, October 2003, December 2003, February 2004, and April 2004.

[29]In one case that resulted in a settlement agreement, the Board also issued the lender a letter of reprimand.

Our analysis of the 32 cases further showed that the Board's effort to review the cases and impose sanctions against lenders or to enter into settlement agreements with them is frequently a time-consuming process. As figure 13 shows, it took an average of 6.7 months from the notice of violation to withdraw lenders' FHA approval and an average of 11.1 months to reach settlement agreements. For the one case where the Board assessed a civil money penalty, it took 27.6 months from the notice of violation to complete the action. The process is even lengthier when considering the time elapsed between the referral and the final Board action. It took an average of 10.3 months from the referral to withdraw lenders' FHA approval and an average of 17.7 months to reach settlement agreements. It took 34.8 months from the referral to assess one lender a civil money penalty.

Figure 13: Status of the Mortgagee Review Board's Actions on 32 Cases as of June 2004

	Type of Board action	Number of cases	Average number of months elapsed: Since notices of violation	Since referrals
Completed	Lender's FHA approval was withdrawn	8	6.7	10.3
	Lender entered into a settlement agreement	20	11.1	17.7
	Lender assessed a civil money penalty	1	27.6	34.8
Pending	Board and lender attempting to reach a settlement agreement	2	7.4	12.0
	Board pursuing a civil money penalty	1	13.8	20.8

Source: GAO analysis of data provided by the Mortgagee Review Board.

The length of time required by the Board to complete its actions allowed nine of the lenders to continue making FHA-insured loans for over a year without being held accountable for their violations. For example, in April 2003, the Board sent a notice of violation to one of these lenders because the lender had committed several violations, including allowing non-FHA approved entities to originate loans, failing to properly verify borrower information, and charging excessive and/or unallowable fees. By the time the Board withdrew the lender's FHA approval in April 2004, the lender had made 584 additional FHA-insured mortgage loans.

The length of time required for the Board to withdraw lenders' FHA approval has improved somewhat since our April 2000 report. We found then that, for the six cases completed during our time frame for that report, it took an average of 8.5 months from the notice of violation to withdraw lenders' FHA approval (as opposed to 6.7 months for the completed cases we reviewed in June 2004).[30] The length of time required for settlement agreements is about the same. We reported in April 2000 that it took an average of 11.2 months to reach the five completed settlement agreements, which is similar to the 11.1 months for the completed cases we reviewed in June 2004. At that time, Board officials told us that they had taken some steps to speed up the process. For example, the Board's secretary told us that in December 1998 the Board had adopted a policy of meeting every 2 months to consider case referrals. This official told us that prior to adopting this policy, the Board did not have an established meeting schedule and met only whenever a sufficient number of cases had accumulated for review. Also, to speed up the settlement agreement process, the Board planned in future violation letters to ask the lenders whether they would be willing to settle their cases and, if so, under what terms and conditions.

HUD officials recognize that the Mortgagee Review Board process can be time-consuming and have taken some steps to speed it up. They noted that progress on certain cases can be slowed when HUD's Office of Inspector General requests that the Board place a hold on the processing of cases against lenders until the Inspector General has completed its investigations. During fiscal years 2003 and 2004, the Inspector General asked for a hold on 14 cases. In accordance with its plans, the Board has started asking lenders prior to Board meetings whether they would be willing to settle their cases. If a lender's settlement offer is acceptable to the Board, a settlement agreement can be prepared and signed immediately. If a lender's offer is not acceptable, the Board can then make its own proposal for settling the case. Also, the Board has hired new staff and plans to implement an internal quality control process by the end of calendar year 2004.

[30]We reviewed 24 cases involving single-family housing lenders that the Board acted on from October 1998 through April 1999. As of November 1999, the Board had completed action on 11 of the cases, while action was still pending on 13 cases.

Conclusions

FHA insures tens of billions of dollars in mortgages for single-family homes each year. While FHA's Mutual Mortgage Insurance Fund is financially healthy, poor lending practices could adversely affect the Fund's financial position. Because lenders underwrite virtually all FHA-insured mortgages without HUD's prior review, it is essential that HUD allow only qualified lenders to participate in its single-family programs, adequately monitor lenders and loans to assess the risks they pose, and hold lenders accountable for the quality of the loans they make.

Contrary to HUD's guidance, the homeownership centers have granted direct endorsement authority to some lenders that did not demonstrate performance that is acceptable under HUD's criteria. Ensuring that the lenders that are being granted direct endorsement authority demonstrate acceptable performance would better assure HUD that these lenders are qualified to underwrite loans without HUD's prior review. By not following HUD's guidance, the homeownership centers may be exposing the department to unreasonable insurance risks.

The homeownership centers generally use a risk-based approach to monitoring, which helps them to focus on the lenders and loans posing a high insurance risk to the department. However, HUD's oversight of lenders could be improved. First, while the homeownership centers are targeting high-risk lenders for examination, they do not always conduct these reviews on-site at the lenders' offices, even though HUD's guidance states that on-site reviews are the preferred method of monitoring. Tracking the lender review process to distinguish between desk and on-site reviews would help HUD ensure that the majority of high-risk lender reviews continue to be conducted on-site. Second, contrary to HUD's guidance, the homeownership centers have not consistently targeted for technical reviews loans made by newly approved lenders. This lack of consistency is due in part to weaknesses in the information system (CHUMS) HUD uses to select loans for technical reviews. Third, the ratings that are assigned during technical reviews do not currently reflect the different levels of risk that underwriting errors pose to the insurance fund. The homeownership centers have proposed revisions to the rating system, which, if implemented, may better ensure the usefulness of technical reviews in identifying the lenders that pose the greatest insurance risk to the department. Because of these conditions, HUD's lender reviews and technical reviews are not as effective as they could be in mitigating financial losses to the department.

HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations. HUD's reviews show that numerous lenders did not comply with FHA's underwriting requirements, yet HUD's homeownership centers have suspended the direct endorsement authority of relatively few lenders. Even though the technical review rating system as currently implemented does not properly reflect the risk that different underwriting errors pose to the insurance fund, the extent of lender noncompliance revealed by the reviews indicates that more lenders may be candidates for enforcement action. By failing to suspend poorly performing lenders, HUD leaves itself vulnerable to lending practices that increase the department's insurance risk.

Recommendations for Executive Action

To improve HUD's oversight of FHA mortgage lenders, we recommend that the Secretary of HUD direct the Assistant Secretary for Housing-Federal Housing Commissioner to take the following five actions:

- Ensure that the homeownership centers are following the guidance for granting direct endorsement authority.
- Track lender reviews to distinguish between desk and on-site reviews.
- Enhance FHA's information system to ensure that the first 30 loans made by new direct endorsement lenders are reviewed as required.
- Expeditiously complete efforts to revise the technical review rating system so that the ratings better reflect the risks that different underwriting errors pose to the FHA insurance fund.
- Develop and implement guidance specifying the conditions under which a homeownership center must suspend a lender's direct endorsement authority.

Agency Comments and Our Evaluation

We provided a draft of this report to HUD for its review and comment. In a letter from the Assistant Secretary for Housing-Federal Housing Commissioner (see app. II), HUD agreed with our five recommendations. Specifically, HUD:

- agreed that it would update its guidance for granting direct endorsement authority and ensure that the homeownership centers consistently apply the requirements for granting direct endorsement authority;
- stated that its lender tracking system had been modified to distinguish between desk and on-site reviews;
- noted that it was aware of the limitations of its information system to accurately identify and count the first 30 loans made by new direct endorsement lenders, and was pursuing system enhancements to ensure that loans made by new direct endorsement lenders are reviewed as required;
- stated that it was in the final phase of implementing a new technical review rating system, to be completed by January 2005; and
- stated that it was currently developing consistent standards for returning lenders to preclosing status (i.e., suspending lenders' direct endorsement authority) and that implementation would occur by January 2005.

HUD also highlighted its program accomplishments, commenting that, while the report acknowledges that FHA has implemented policy and procedural changes since our last review, it does not fully recognize the substantial achievements and accomplishments that resulted from these changes. The department described improvements in lender monitoring, lender approval and recertification, and lender training, among other things. While we agree that HUD has made improvements, a number of the accomplishments cited were outside the scope of our review. Our draft report recognized a number of specific improvements that were relevant to our objectives. For example, we noted that HUD had revised its guidance for granting direct endorsement authority and started targeting lenders and loans for review based on risk.

HUD also disagreed with some of our findings. First, HUD stated that our discussion of the percentages of lenders targeted and reviewed (figs. 5 and 6) did not acknowledge that target reports developed each quarter to identify the lenders to be reviewed are fluid and decisions regarding which lenders to review are subject to outside influences. For example, staff may be directed to complete other reviews based on information from sources other than Neighborhood Watch. HUD also noted that the reviews not completed during the quarter are carried over to the subsequent quarter and nearly all are completed. We included figures 5 and 6 in our draft report as empirical evidence supporting our statement that the homeownership centers generally were reviewing the lenders on their targeting list. Further, our draft report—in the text preceding figure 4—acknowledged that the centers used other information to develop their targeting lists, specifically citing examples such as the existence of complaints about lenders. Nevertheless, we added to this text based on HUD's comments.

Second, regarding the Mortgagee Review Board, HUD noted that the Board carries out a highly regulated administrative process that may lead to serious sanctions and penalties for lenders; therefore, the department is obligated to afford maximum due process to these lenders. HUD also stated that our conclusion that the length of time it takes for the Board to act on a case allows a lender to continue with inappropriate practices is misleading because (1) HUD staff communicate the findings of lender reviews to lenders during mandatory exit conferences and (2) the Board has the ability to suspend a lender or move a case quickly through the process when significant problems are found. We do not agree that the statement is misleading. Our report stated that the length of time required by the Board to complete its actions allowed nine lenders to continue making FHA-insured loans for over a year without being held accountable for their violations. While HUD may notify a lender of violations found during a lender review, such notification does not guarantee that the lender will choose to correct or improve its practices. Finally, although the Board has the ability to suspend lenders, it did not choose to suspend the nine lenders we highlighted in our report.

HUD agreed with our statement that HUD's preferred method for monitoring is to conduct on-site reviews of lenders. It also noted that the difference between a desk review and an on-site review is minimal, but went on to say that its tracking system had been modified to distinguish between desk and on-site reviews. Finally, HUD stated that it anticipates publication of the Credit Watch regulation discussed in the report by the second quarter of fiscal year 2005.

We are sending copies of this report to the Secretary of Housing and Urban Development and to other interested congressional committees. We also will make copies available to others upon 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 regarding this report, please contact me at (202) 512-8678 or woodd@gao.gov or Paul Schmidt at (312) 220-7681 or schmidtpj@gao.gov. Staff contacts and other key contributors are listed in appendix III.

David G. Wood

David G. Wood
Director, Financial Markets and
Community Investment

Objectives, Scope, and Methodology

Our objectives were to examine (1) how well the Department of Housing and Urban Development (HUD) follows its guidance when granting lenders direct endorsement authority, (2) the extent to which HUD uses a risk-based approach when monitoring the lenders participating in the Federal Housing Administration's (FHA) mortgage insurance programs, and (3) the extent to which HUD is holding lenders that it identifies as not complying with its requirements accountable for their performance.

To determine how well HUD follows its guidance when granting lenders direct endorsement authority, we reviewed HUD's regulations, procedures, and other guidance relating to its process for approving lenders and granting lenders direct endorsement authority. Lenders with direct endorsement authority can underwrite and close FHA-insured mortgage loans without prior FHA review or approval. We interviewed officials from HUD's Office of Lender Activities and Program Compliance, Office of Single Family Program Development, and its four homeownership centers. We requested from each homeownership center the number of lenders that entered the probationary period on or after October 1, 2002, and were granted direct endorsement authority by April 30, 2004. We chose October 1, 2002, as the start date because HUD revised its guidance for granting lenders direct endorsement authority in September 2002. We used April 30, 2004, as our ending date because we visited the four homeownership centers in May and June 2004. For each of the 49 lenders that were approved during this time period, we reviewed documentation maintained by the centers and entered the ratings that the lender received on the mortgages it submitted to the center into a data collection instrument.[1] All of the data collected was independently verified. We then analyzed the data to determine whether the centers followed FHA's procedures for granting lenders direct endorsement authority.

To determine the extent to which HUD is using a risk-based approach when monitoring lenders, we reviewed HUD's guidance and procedures for conducting lender reviews (i.e., reviews of lenders' operations by HUD staff) and technical reviews (i.e., reviews of individual loans performed after approval of mortgage insurance to assess the quality of lenders' underwriting practices). We reviewed HUD's use and oversight of contractors that perform technical reviews. We interviewed officials at

[1] One additional lender, which already had direct endorsement authority, was granted the authority to underwrite Home Equity Conversion Mortgages (HECM)—mortgages that can be used by senior homeowners to convert equity into income.

each of the centers on a variety of issues dealing with lender reviews and technical reviews. The issues discussed included the (1) centers' criteria for targeting loans and lenders for review, (2) number of off-site lender reviews, (3) the number and type of "poor" ratings assigned during technical reviews, and (4) procedures for monitoring the work of technical review contractors. We also interviewed Fannie Mae and Freddie Mac to discuss their efforts to monitor the lenders that participate in their programs.

In addition to these steps, we obtained and analyzed lists of the lenders that the homeownership centers targeted for lender reviews in fiscal year 2003 and the first two quarters of fiscal 2004 and the lenders they reviewed during the same time period. (We analyzed six quarters of data to ensure that the most recent data was considered.) We compared the lenders reviewed with those that were targeted to assess the extent to which HUD was performing lender reviews on lenders that it considered to pose a high risk to the insurance fund. We also analyzed the data to determine the percentage of targeted lenders that were reviewed.

To determine the extent to which the homeownership centers were reviewing the first 30 loans made by new direct endorsement lenders, we analyzed data from HUD's Single Family Data Warehouse on the loans endorsed by the 49 direct endorsement lenders that entered the probationary period on or after October 1, 2002, and were granted direct endorsement authority by April 30, 2004. Only 16 of the 49 lenders had endorsed loans as of June 19, 2004.

To determine the percentage of "poor" ratings each lender received during technical reviews, we analyzed data from HUD's Underwriting Reports System for fiscal year 2003 and the first two quarters of fiscal 2004. When we requested the data from each homeownership center, the Philadelphia and Santa Ana centers provided just the technical reviews where the review date was within our six-quarter time frame. In contrast, the Atlanta and Denver centers provided databases that included reviews outside our scope (including reviews where the review date was blank). To be consistent with the data that the other two centers provided, we limited our analysis of the data provided by Atlanta and Denver to just those technical reviews where the review date was within our six-quarter time frame. We used this data to determine the percentage of "poor" ratings assigned during technical reviews and the most common deficiencies cited during technical reviews.

To determine the extent to which HUD is holding lenders that it identifies as not complying with its requirements accountable for their performance, we reviewed HUD's regulations and policy guidance to determine the enforcement options available to HUD. We interviewed officials from HUD's Office of Lender Activities and Program Compliance, Enforcement Center, and Mortgagee Review Board. At each of the four homeownership centers, we discussed with cognizant officials each center's efforts to take enforcement actions against lenders that have violated program requirements. We determined the number and types of lenders sanctioned by HUD under its Credit Watch program as of the end of July 2004. In June 2004, we reviewed the Board's files for the 32 cases involving single-family mortgage lenders that the Board had acted on in the previous 12 months and determined the nature and status of the Board's actions. In addition, we analyzed data to determine the length of time it took the Board to take action against these lenders.

To assess the reliability of the various HUD data we used, we discussed the data with knowledgeable agency officials, reviewed information about the systems, and performed electronic testing to detect obvious errors in completeness and reasonableness. We determined that these data were sufficiently reliable for the purposes of this report.

We performed our work from December 2003 to September 2004 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, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

OCT 27 2004

Mr. David Wood, Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Wood:

Thank you for permitting the Federal Housing Administration (FHA) the opportunity to address the Draft Report, "Single Family Housing: Progress Made, but Opportunities Exist to Improve HUD's Oversight of FHA Lenders." While the report acknowledges that FHA has implemented policy and procedural changes since the last GAO audit, performed in 2000, it does not fully recognize the substantial achievements and accomplishments that resulted from these changes. FHA believes it is not only appropriate, but also necessary for the report to clearly present and highlight these significant achievements. FHA's response to the GAO report is organized into three sections: 1) Program Accomplishments; 2) Response to GAO Findings/Factual Errors; and 3) Response to Recommendations for Executive Action.

Section 1: Program Accomplishments

Since publication of the April 2000 GAO report, "Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk," FHA has made significant and dramatic improvements. These accomplishments and activities are listed below:

A) Lender Monitoring

- Since GAO's last audit, FHA has conducted over 900 monitoring reviews per year, and has targeted these reviews more precisely on the lenders that pose the greatest risk to FHA. Although the number of lender monitoring reviews conducted has remained fairly stable, the actions and sanctions resulting from the reviews have increased. In several important categories, the number of sanctions or the dollar amount have more than doubled; referrals to HUD's Office of Inspector General (OIG) have more than quintupled.

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The following table represents actions/sanctions taken with respect to lenders, comparing approximately the three years prior to GAO's last audit with the three years since the audit.

LENDER ACTIONS/SANCTIONS	FY 1998 – 2000	FY 2001 – 2003
Lender monitoring reviews	2,297	2,777
Lenders sanctioned by the MRB	128	137
Lenders withdrawn by the MRB	28	36
Civil Money Penalties Assessed by the MRB	$6.17m	$6.5m
Lenders Assessed Civil Money Penalties by the MRB	103	116
Indemnifications Executed (MRB & Lender Monitors)	3,220	8,937
Indemnifications (potential savings to the FHA Funds)	$96.6m*	$209m**
Suspensions/Proposed Debarments/Final Determinations	942	1,767
Referrals to OIG for investigations	204	1,101

*** The dollar amount is based on the historical average loss of $30,000**
**** The dollar amount is based on the more recent average loss of $23,300**

- For FY 2004, the actions and sanctions resulting from risk-based lender monitoring reviews remain at the same high level. For example, the Mortgagee Review Board took action against 32 lenders, withdrew the FHA approval of 8 of them, and assessed $2.33 million in civil money penalties. Nearly 2,600 indemnification agreements were executed, for a potential savings to the FHA Insurance Funds of more than $60 million. In addition, over 250 referrals were made to the OIG for further investigation.

- FHA has lowered the Credit Watch threshold from 300% of the local field office early default rate, to 200%. FHA started this process in FY 2003, gradually lowering the Credit Watch threshold each quarter, and fully implemented the 200% standard beginning with the first quarter of FY 2004. The effect of the new threshold is shown by the increased number of lenders targeted for termination in recent quarters, as documented in Figure 12 of the GAO draft report. Since Credit Watch started in May 1999, FHA has terminated 261 lender branches, placed 219 branches on warning status, and currently has another 14 branches under review.

- FHA has enhanced the Neighborhood Watch Early Warning system to make available additional lender and loan data and offer the flexibility to sort and array this information in a variety of optional standard reports. HUD uses Neighborhood Watch to perform risk-based targeting of lenders for on-site lender reviews, but the tool has also proven to be a valuable asset to HUD's OIG. The lending industry uses the system as a self-policing tool to monitor the performance of its branches and overall operations as well as for monitoring current and potential business partners. It is available to the public and

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used by consumer advocacy groups to monitor lenders' performance within their communities.

- FHA has implemented a "Comprehensive Review" approach for its largest lenders. Instead of reviewing the largest lenders at only the branch level, these in-depth reviews are designed to evaluate a lender's entire operation, focusing on institutional loan volume, the activities of the lender's retail sponsors, underwriting, servicing policies and procedures, and any high-risk areas of its business.

B) Lender Approval and Recertification

- FHA's new lender recertification procedures also enhance FHA's ability to mitigate risk. The Lender Assessment Sub-System (LASS), implemented in September 2002, uses early warning indicators to identify FHA-approved lenders that fail to meet FHA financial requirements or that are experiencing financial stress. By flagging financially unstable lenders, LASS enables FHA to quickly deny recertification to lenders that pose a risk to FHA. Under the previous manual recertification procedures, FHA required on average 90 to 180 days to determine which lenders required removal, produce and send a notification of deficiency letter, and terminate the lender. Now, FHA knows within one hour of the lender's recertification due date whether the lender is deficient and can immediately issue a 30-day deficiency notice, followed by a termination notice if the problems are not corrected within 30 days. LASS also provides FHA a more comprehensive financial analysis and assessment of a lender's risk to FHA. FHA removes on average 1500 lenders per year, and the improved efficiency has allowed FHA to devote staff to other lender oversight activities.

- FHA has implemented the "*pay.gov*" system to allow lenders to pay their annual recertification fee electronically via the FHA Connection.

- FHA has completed implementation of LASS for submission and analysis of over 5,500 annual recertification audits. FHA has dedicated 5 full-time, licensed, professional auditors to review all audits identified as deficient.

- FHA has enhanced the LASS system to allow additional electronic processing of termination appeals and targeting of lenders for on-site reviews based on key financial indicators, such as: net profitability, measured by net income to total assets; available liquid capital, measured by current assets minus current liabilities; capacity to meet ongoing fixed expenses, measured by current assets to current liabilities; and overall debt, measured by total liabilities to total assets. These indicators for individual lenders will be compared to industry benchmarks as well as lender peer groups.

- FHA has reorganized the Lender Approval and Recertification Division into two branches to improve management of the approval and recertification functions.

C) Mortgagee Review Board

The Mortgagee Review Board function was transferred back to the Office of Lender Activities and Program Compliance (OLA) from the Office of General Counsel, Departmental Enforcement Center, in late November 2003. In less than a year, OLA has taken a number of actions to improve the coordination between the participants involved, while streamlining the process. Personnel changes in the Board staff have resulted in a better mix of skills and experiences. The position of Secretary to the Board has also been merit staffed.

D) Regulations

Since GAO's previous report, FHA has published five final rules to strengthen lender accountability and improve lender compliance with FHA requirements. Summaries of the final rules are provided below:

- Final Rule FR-4592-F-02 (Effective August 9, 2002), Single Family Mortgage Insurance; Section 203(k) Consultant Placement and Removal Procedures enacted 24 CFR §200 & §203, establishing placement and removal procedures for HUD's list of qualified consultants under the Section 203(k) Rehabilitation Loan Insurance Program. A 203(k) lender may select a qualified independent consultant, who is an expert in the field of home inspection, cost estimating, and construction, to perform various tasks required for the rehabilitation of the property. The establishment of these placement and removal procedures better protects 203(k) borrowers and lenders as well as safeguards the FHA insurance fund.

- Final Rule FR-4615-F-02 (Effective June 2, 2003), Prohibition of Property Flipping in HUD's Single Family Mortgage Insurance Programs enacted 24 CFR §203.37 and amended § 203.255, to prohibit property "flipping," the practice whereby a property recently acquired is resold for a considerable profit with an artificially inflated value, often abetted by a lender's collusion with the appraiser. Specifically, the final rule prohibits FHA insured financing of properties purchased and resold within a 90 day period and requires additional information on properties resold in 90 to 180 days that increase in value by 100%. The new requirements are designed to protect FHA homebuyers from becoming victims of predatory flipping activity.

- Final Rule FR-4620-F-02 (Effective June 16, 2003), Appraiser Qualifications for Placement on FHA Single Family Appraiser Roster, amended 24 CFR §200.202 & §200.24, strengthening the licensing and certification requirements for placement on the FHA Appraiser Roster. Appraisers on the FHA Appraiser Roster must have credentials that are based on the minimum licensing/certification standards issued by the Appraiser Qualifications Board of the Appraisal Foundation. The final rule also provides that an appraiser whose license or certification in any state has been revoked, suspended, or surrendered as a result of a state disciplinary action will be automatically suspended from the Roster until HUD receives evidence that the state imposed sanction has been lifted.

- Final Rule FR-4720-F-02 (Effective April 9, 2004), FHA Inspector Roster enacted 24 CFR §200.170, 200.171, and 200.172, establishing the FHA Inspector Roster eligibility requirements and procedures for placement of inspectors on the Roster, recertification of Roster inspectors, and removal of inspectors from the Roster. In addition, the Rule announces implementation of a national inspector examination and identifies when a mortgagee must use an inspector listed on the Roster. The examination will test the applicant's knowledge and understanding of FHA requirements and residential building standards. An FHA Roster Inspector is required for new construction, either when there is no local inspection authority or if the lender, for whatever reason, elects not to have inspections performed by the local jurisdiction. For existing construction, FHA requires an inspection when repairs are of a structural nature and a licensed engineer or other person specifically licensed to conduct an inspection is not available.

- Final Rule FR-4722-F-02 (Effective August 19,2004) FHA Single Family Mortgage Insurance; Lender Accountability for Appraisals amended 24 CFR § 25 & 203, reaffirming that lenders are accountable for the quality of appraisals on properties securing FHA-insured mortgages. Specifically, lenders that submit appraisals to HUD that do not meet FHA requirements may be subject to the imposition of sanctions by the HUD Mortgagee Review Board. The codification of theses policies provides HUD additional enforcement authority, reminds lenders of their responsibilities with respect to appraisals, and ensures that homebuyers receive an accurate statement of the appraised value of their homes.

E) Training

National Lender Training: FHA conducted National Lender Training that covers a variety of topics, including: FHA lender approval, underwriting, closing, TOTAL Scorecard, appraisal requirements, quality assurance, and servicing requirements. Training sessions were conducted in 4 locations during FY 2004 (Orlando, FL; Philadelphia, PA; Denver, CO and Atlanta, GA), and a session will be held in Santa Ana, CA in November 2004. The training offers lenders and appraisers comprehensive information on FHA's policies, procedures, and requirements. The purpose of the training is to improve lender compliance, and thereby to reduce risk to FHA. To date, more than 1,000 lenders and appraisers have participated in the national training. All participants were provided comprehensive training manuals that can be used for future reference.

Local Training: The FHA Homeownership Centers (HOCs) conduct more than 200 local training sessions each fiscal year. The topics include, but are not limited to, underwriting, the TOTAL Scorecard, FHA appraisal requirements, loss mitigation, and FHA Connection. The local training supplements the national training, offering more detailed information on FHA's requirements. Approximately 50 to 100 participants are served in each training session.

F) TOTAL Mortgage Scorecard Deployment

FHA's mortgage scoring algorithm was deployed in January 2004. TOTAL became mandatory for new scored loans made after May 1, 2004 and for all scored loans made after August 1, 2004. The data captured by the scorecard, especially the credit bureau scores, allow FHA to better understand and evaluate the overall credit risk of mortgages entering its portfolio. This data also allows FHA to examine individual lender portfolios, to analyze differences between product offerings (for example, whether there are discernible differences in the credit quality of borrowers seeking adjustable rate mortgages compared to those seeking fixed-rate mortgages), to identify high-risk mortgages, and to better estimate default/claim assumptions.

G) Updated Mortgage Credit Underwriting Handbook

FHA published a revised mortgage credit handbook (HUD-4155.1, "Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties") at the beginning of FY 2004. The handbook, last revised in 1995, incorporated all major credit policy revisions made since then, which were outlined in 50 mortgagee letters published between September 1995 and September 2003. The handbook also clarified those policy areas that may have been open to interpretations by lenders that did not conform to FHA's original intention.

H) Updated Mortgagee Letters to Eliminate Fraud and Reduce Program Risks

FHA has implemented initiatives that enhance FHA's ability to mitigate risks to the FHA Insurance Funds by identifying negligent and/or fraudulent activity associated with underwriting FHA mortgage loans.

- FHA issued Mortgagee Letter 2004-13, announcing that FHA lenders must enter credit bureau scores for mortgages underwritten without benefit of automated technology. This requirement allows FHA to examine the credit quality of these mortgages with the same level of precision as those mortgages scored by TOTAL. Going forward, virtually all mortgages made to individuals will have credit scores available in FHA's CHUMS system, which will enable FHA able to examine the quality of these loans and be better able to predict default/claim trends, just as the agency does with mortgages scored through FHA's TOTAL mortgage scorecard.

- FHA issued Mortgagee Letter 2004-17 on Social Security Number verification. This initiative reduces the likelihood that a borrower on a FHA mortgage is using a false social security number or otherwise committing identity theft and fraud in connection with obtaining an FHA-insured mortgage.

- FHA issued Mortgagee Letter 2004-28, prohibiting several risky credit policy practices. The Mortgagee Letter requires that for new construction transactions, the lender underwrite the mortgage using a realistic estimate of property taxes once the taxing authority has reassessed the improvements on a property. Previously, some lenders ignored the eventual increase in the monthly taxes, with disastrous results when the homeowner was unable to absorb the large mortgage payment increase. Now, the lender must be satisfied that the homeowner has the income to support the increased payment. In addition, due to the unacceptable performance of mortgages underwritten with buy-down accounts, this Mortgagee Letter prohibits the lender from using the buy-down rate to qualify the borrower for a mortgage. Together, these two changes will result in a reduced incidence of early defaults stemming from the shock of increased payments.

Section 2: Response to GAO Findings/Factual Errors

FHA is concerned that the draft report contains several significant factual errors. A list of these errors, along with the appropriate correction, is provided below:

Now on pp. 15-16.

On pages 16 – 17 of the draft report, GAO's discussion of Figures 5 and 6 does not acknowledge that target reports developed each quarter to identify the lenders to be reviewed are fluid and decisions regarding which lenders to review are subject to outside influences. All four HOCs target lenders quarterly for review. The Quality Assurance Division (QAD) attempts to complete all of the lender reviews on the schedule. At times, staff may be directed to complete other reviews based on information from sources other than Neighborhood Watch, which is the underlying targeting tool. For example, changes may result if there are a large number of complaints about a particular lender. Also, during a review, monitors sometimes discover a further problem with the lender and the review may take longer than expected. In other instances, OIG Investigation and Audit staff have contacted FHA and requested that the agency not review a lender listed on the quarterly schedule. In several cases, the lender targeted went out of business, was acquired, or merged. Normally, the reviews not completed during the quarter are carried over to the subsequent quarter and nearly all are completed.

Now on p. 17.

On page 18 of the draft report, GAO states that HUD's preferred method for monitoring is to conduct on-site reviews of lenders. This is true, and over 92 percent of the lender reviews completed in FY 2003 were on-site reviews. A desk review may be appropriate for a focused review that emphasizes a specific file review method; also it may be necessary when travel funds are constrained. Desk reviews are an acceptable method of review and, as implemented, the use of desk reviews has been consistent with outstanding FHA policy guidance.

The difference between a desk review and an on-site review is minimal; the primary difference concerns checking the facilities and signage. The most important aspect of a lender review (whether on-site or desk) involves sifting through files to evaluate compliance with FHA requirements, contacting borrowers and other parties to the transaction, and verifying data. In fact, desk reviews are as likely as on-site reviews to result in significant outcomes, such as Mortgagee Review Board cases, debarments, and fraud referrals to the OIG.

While HUD staff has taken the initiative to use on-site reviews to provide technical assistance to lenders, this is simply an added benefit – it is, however, not the purpose of a monitoring review. HUD offers many other opportunities and avenues for lenders to receive guidance on HUD policies and procedures, including training and Direct Endorsement updates offered by the HOCs, electronic notifications of program policy changes, and most recently, the National Lender Training offered throughout the country.

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On pages 27 – 28 of the draft report, GAO states that HUD has proposed Credit Watch changes to improve the program's effectiveness. In fact, HUD anticipates publication of the Credit Watch regulation by the second quarter of FY2005. Single Family data systems are being modified to permit prompt implementation of the rule.

On page 32 of the draft report, it was correctly noted that the process for Board actions is time-consuming. We appreciate that GAO acknowledges that average processing times have improved. The Department will continue to seek ways to streamline the Board's activities and improve its efficiency, to the extent possible.

However, we believe that it is also important to note that the Mortgagee Review Board carries out a highly-regulated administrative process that which may lead to serious sanctions and penalties for lenders. These sanctions and penalties have the potential to cause severe financial impact on lenders. Therefore, the Department is obligated to afford maximum due process to these lenders. Each case is unique, and there is a high level of review and follow up for the Department to ensure the accuracy and completeness of the documentation supporting the charges made against a lender. Careful deliberations by the Department are essential to ensure that proper actions are taken against the participants involved, and that Board decisions can withstand subsequent legal challenges. Lenders, who may or may not be represented by legal counsel, have the opportunity to challenge the Board's proposed actions through written and oral arguments. Negotiations on any number of issues can, at times, be protracted. In all but the most serious cases the Board strives to reach settlements that are of the most benefit to the government. GAO's reference (page 34) to a lender who originated 584 additional loans before the Board took action is an example of protracted negotiations and legal maneuvering. By taking the extra time to develop its case, HUD obtained a significant settlement from the lender, in which the lender not only paid for its previous violations of HUD policy, but also agreed to change its practices. Absent this extensive case development, HUD would have had to drop the case due to a lack of legal sufficiency.

Now on pp. 33-34.

On page 34, the conclusion that the length of time it takes for the Board to act on a case allows a lender to continue with inappropriate practices is misleading for two reasons. First, as part of its lender monitoring process, the HOC QAD conducts a mandatory exit conference with each lender at the conclusion of the on-site or desk review. This conference is held with the President, CEO, or designee for main offices, and the Branch Manager or designee for branch offices. At the conference, the HUD monitor discusses with the lender problems and deficiencies with loan files and in the lender's operations. The HUD monitor communicates to the lender the severity behind each finding (specific program violation), as well as minor findings, which may have already been resolved by the lender or closed out at the exit conference. Many lenders take actions to correct or improve practices to comply with HUD's specific program requirements before, or shortly after the exit conference. Second, when the monitors discover significant problems that pose a financial risk to FHA or FHA borrowers, the Board has the ability to suspend a lender or move a case quickly through the process to protect the financial interests of the FHA funds and/or the public.

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Section 3: Response to Recommendations for Executive Action

GAO Recommendation: *Ensure that Homeownership Centers are following the guidance for granting Direct Endorsement authority.*

FHA Response: FHA will update its guidance and ensure that all HOCs consistently apply the requirements for granting direct endorsement authority.

GAO Recommendation: *Track lender reviews to distinguish between desk- and on-site reviews*

FHA Response: The lender tracking system has been modified to distinguish between desk and on-site reviews. HUD's reporting has not distinguished between the two because there is little difference between the results of an on-site and a desk review. The source of valid findings has little relevance in the type of action taken by HUD.

GAO Recommendation: *Enhance FHA's information system to ensure that the first 30 loans made by new Direct Endorsement lenders are reviewed as required.*

FHA Response: FHA is aware of the limitations of its information system to accurately identify and count the first 30 loans made by new Direct Endorsement lenders. FHA is pursuing system enhancements to ensure that loans made by new DE lenders are reviewed as required.

GAO Recommendation: *Expeditiously complete efforts to revise the technical review rating system so that ratings better reflect the risk that different underwriting errors pose to the FHA insurance fund.*

FHA Response: As FHA has previously informed GAO, for the past 12 months the agency has been actively engaged in efforts to revise the technical review rating system. FHA is in the final phase of implementation, which is to be completed by January 2005. These efforts have been complex in nature as well as time-consuming since the scope of work encompasses not only changes to operating procedures but also to information systems.

GAO Recommendation: *Standards for Re-Entering Lenders into Pre-Closing Status*

FHA Response: FHA is currently developing consistent standards for returning lenders to pre-closing status. Implementation will occur by January 2005.

Sincerely,

John C. Weicher

John C. Weicher
Assistant Secretary for Housing-
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