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Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

November 2011

FEDERAL HOUSING ADMINISTRATION

Improvements Needed in Risk Assessment and Human Capital Management

GAO-12-15

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G A O
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Highlights

Highlights of GAO-12-15, a report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has helped millions purchase homes by insuring private lenders against losses from defaults on FHA-insured single-family mortgages. In recent years, FHA has experienced a dramatic increase in its market role due, in part, to the contraction of other mortgage market segments. The increased reliance on FHA mortgage insurance highlights the need for FHA to ensure that it has the proper controls in place to minimize financial risks while meeting the housing needs of borrowers. In addition to providing data on FHA's single-family workload, GAO was asked to evaluate (1) FHA's risk assessment strategy, including the extent to which it is consistent with HUD and GAO internal control standards, and (2) steps FHA has taken to manage the risks in its single-family programs. To address these objectives, GAO analyzed data from fiscal years 2006–2010 on single-family business volume and workload, reviewed FHA documents on risk assessment and changes made to manage risks (such as those to human capital), and interviewed FHA officials.

What GAO Recommends

FHA should develop an integrated risk assessment strategy, conduct annual risk assessments, establish ongoing mechanisms to anticipate emerging risks, and develop workforce and succession plans. HUD agreed with the recommendations, stating that it was either currently working toward achieving the recommendations or had plans to do so in the very near future.

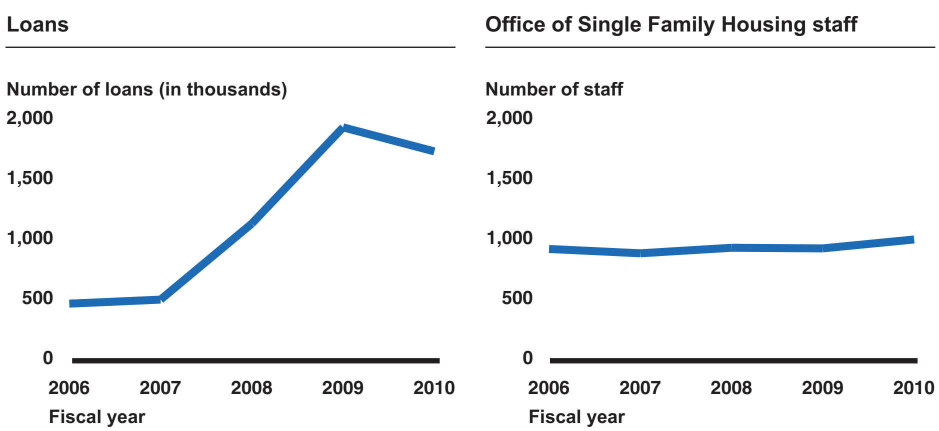
View GAO-12-15. For more information, contact Mathew J. Scirè at (202) 512-8678 or sciremj@gao.gov.

What GAO Found

While FHA has taken steps to identify risks in its single-family programs, it has not combined these risk assessment efforts and lacks annual assessments and tools to anticipate risks from changing conditions. To improve its risk assessment strategy, FHA created a risk office in 2010 and hired a consultant to recommend best practices for its operation. It also began a quality control initiative in the Office of Single Family Housing (SFH), in which program and field offices assess risks and report on efforts to mitigate them. Internal control standards require agencies to have an integrated risk assessment plan. While FHA's consultant recommended integrating risk assessment, SFH's quality control initiative and the risk office's activities remain separate efforts. Although HUD's guidance requires annual risk assessments, SFH has not updated its assessments since 2009. Finally, FHA has not yet acted on the consultant's recommendation to report on emerging risks. Delays in defining the risk office's authority, staff shortages, and changes in FHA leadership have slowed implementation of the new approach. Without integrated and updated risk assessments that identify emerging risks, FHA lacks assurance that it has identified all its risks.

FHA has enhanced efforts to manage risks in its single-family programs, but human capital still presents challenges. To address risk associated with lenders and appraisers, FHA reduced the number of lenders directly participating in the program and revised its oversight. FHA addressed some risks related to staffing but lacks strategic workforce and succession plans. HUD and GAO standards require workforce planning that identifies critical skills needed to meet future needs, defines skill gaps, and considers succession planning. Although it has determined that SFH needs more staff, FHA has not created a workforce plan that systematically identifies critical skills and gaps in skills. Also, 63 percent of homeownership center staff (who conduct most day-to-day functions) are eligible to retire in the next 3 years, but FHA has not developed a plan to manage retirements or hire staff with needed skills. Without a workforce planning process that includes succession planning, FHA's ability to systematically identify workforce needs is limited.

Number of FHA Loans and Single-Family Staff, 2006–2010



Source: GAO analysis of FHA data.

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Abbreviations

CHUMS	Computerized Home Underwriting Management System
FHA	Federal Housing Administration
FTE	full-time equivalent
HUD	Department of Housing and Urban Development
IG	Inspector General
IT	information technology
LTV	loan-to-value
PSD	Program Support Division
OCSD	Operations and Customer Service Division
ORM	Office of Risk Management
PETR	post-endorsement technical review
PUD	Processing and Underwriting Division
QAD	Quality Assurance Division
REAP	Resource Estimation and Allocation Process
REO	Real Estate Owned Division
SFH	Office of Single Family Housing
TOTAL	Technology Open to Approved Lenders

United States Government Accountability Office
Washington, DC 20548

November 7, 2011

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) has helped millions of families purchase homes through its single-family mortgage insurance programs. In recent years, FHA has experienced a dramatic increase in its market role due, in part, to the contraction of other mortgage market segments. At the same time, it has faced fiscal challenges. As we reported in September 2010, FHA is not meeting statutory capital reserve requirements.[1] Additionally, although FHA's single-family insurance programs historically have produced budgetary receipts for the federal government, a weakening in the performance of FHA-insured loans could increase the possibility that FHA will require additional funds to help cover its costs on insurance issued to date.[2] The increased reliance on FHA mortgage insurance highlights the need for FHA to ensure that it has the proper controls in place to minimize financial risks while meeting the housing needs of borrowers.

Your committee asked us to examine FHA's oversight capacity in light of the recent expansion in single-family mortgage insurance programs. Specifically, this report discusses (1) recent changes in FHA's volume, workload, and resources; (2) FHA's risk assessment strategy, including the extent to which it is consistent with HUD and GAO internal control standards; and (3) steps FHA has taken to manage the risks in its single-family mortgage insurance programs.

[1]See GAO, *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition*, GAO-10-827R (Washington, D.C.: Sept. 14, 2010).

[2]As of August 31, 2011, FHA had about 7.3 million single-family mortgages in force with an outstanding balance of over $1.0 trillion.

To determine changes in FHA's single-family business volume, we analyzed data on business volume and market share from FHA's quarterly reports to Congress and quarterly reports on U.S. housing market conditions. To determine how FHA's workload has changed, we analyzed data for 2006–2010 from various HUD information systems.[3] We also analyzed data on staff assigned to the Office of Single Family Housing in 2006–2010 and contractor staff hired to perform selected functions. To assess the reliability of these data, we reviewed documentation from FHA, interviewed FHA officials who administer these information systems and officials who routinely use these systems for workload management, and verified selected data across multiple sources. We determined that the data were sufficiently reliable for our purposes. To determine the extent to which FHA's risk assessment strategy is consistent with GAO's and HUD's risk assessment requirements and guidelines, we reviewed Federal Managers' Financial Integrity Act requirements, our internal control standards and evaluation tool, HUD's management control handbook, and Office of Management and Budget Circular No. A-123 requirements regarding an internal control structure for risk assessment. To identify FHA's risk assessment strategy, we reviewed (1) quality management plans and examples of risk assessment worksheets, quarterly statements, and other documentation for the Office of Single Family Housing's internal quality control initiative and (2) a report on the proposed structure and functions of the Office of Risk Management and Regulatory Affairs. We also interviewed Office of Single Family Housing and Office of Risk Management and Regulatory Affairs staff. We then compared FHA's risk assessment strategy with our internal control standards and HUD's guidance. To describe the steps FHA has taken to manage the risks it has identified, we reviewed changes to regulations and FHA guidance that address credit risk and risks associated with lenders and appraisers. To determine the advantages and disadvantages of changes FHA has made to its oversight of lenders and appraisers, we reviewed relevant documents and interviewed FHA officials and officials at trade organizations representing large and small lenders. To determine the steps FHA has taken to manage the risks associated with its information systems, we reviewed documents related to FHA's efforts to transform its information systems and interviewed the FHA Transformation Initiative program manager. To assess the steps FHA has taken to address its staffing needs, we

[3] Unless otherwise stated, the years shown in this report are fiscal years.

reviewed the 2009 Resource Estimation and Allocation Process study for Single Family Housing field staff and HUD's Strategic Human Capital Plan. We also interviewed FHA officials about their workforce and succession planning and obtained any related documents. We compared this information with our internal control standards and HUD's human capital guidance.

We conducted this performance audit from October 2010 to November 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix I contains additional information on our scope and methodology.

Background

FHA's single-family programs insure private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units.[4] FHA insures a variety of mortgages for initial home purchases, construction and rehabilitation, and refinancing. It also insures reverse mortgages, a type of loan against the borrower's home that is available to persons 62 years or older and allows them to convert home equity into flexible cash advances while living in their homes. In 2010, FHA insured over 1.7 million single-family mortgages representing about $319 billion in mortgage insurance. The agency has played a particularly large role among minority, lower-income, and first-time homebuyers. In 2010, almost 80 percent of FHA-insured home purchase loans went to first-time homebuyers, 30 percent of whom were minorities. FHA generally is thought to promote stability in the market by helping to ensure the availability of mortgage credit in areas that may be underserved by the private sector or that are experiencing economic downturns.

Legislation sets certain standards for FHA-insured loans. FHA borrowers who are purchasing a home are required to make a cash investment of at least 3.5 percent of the current purchase price. This investment may come from the borrowers' own funds or from certain third-party sources.

[4]FHA also insures mortgages for multifamily properties and health care facilities.

However, borrowers are permitted to finance their mortgage insurance premiums and some closing costs, which can create an effective loan-to-value (LTV) ratio—that is, the ratio of the amount of the mortgage loan to the value of the home—of close to 100 percent for some FHA-insured loans. Congress also has set limits on the size of the loans FHA may insure, which can vary by county. For the period from January 1, 2011, through September 30, 2011, the limits ranged from $271,050 to $729,750 for one-unit properties in the continental United States. Starting October 1, 2011, the limits ranged from $271,050 to $625,500 for these properties.

FHA insures almost all of its single-family mortgages under its Mutual Mortgage Insurance Fund (the Fund). The Fund is supported by borrowers' insurance premiums. FHA has the authority to establish and collect a single up-front premium (in an amount not to exceed 3.0 percent of the amount of the original insured principal obligation of the mortgage) and annual premiums of up to 1.5 percent of the remaining insured principal balance, or 1.55 percent for borrowers with down payments of less than 5.0 percent. Since April 18, 2011, FHA has charged a 1.00 percent up-front premium and a 1.10 or 1.15 percent annual insurance premium, depending on the LTV ratio.

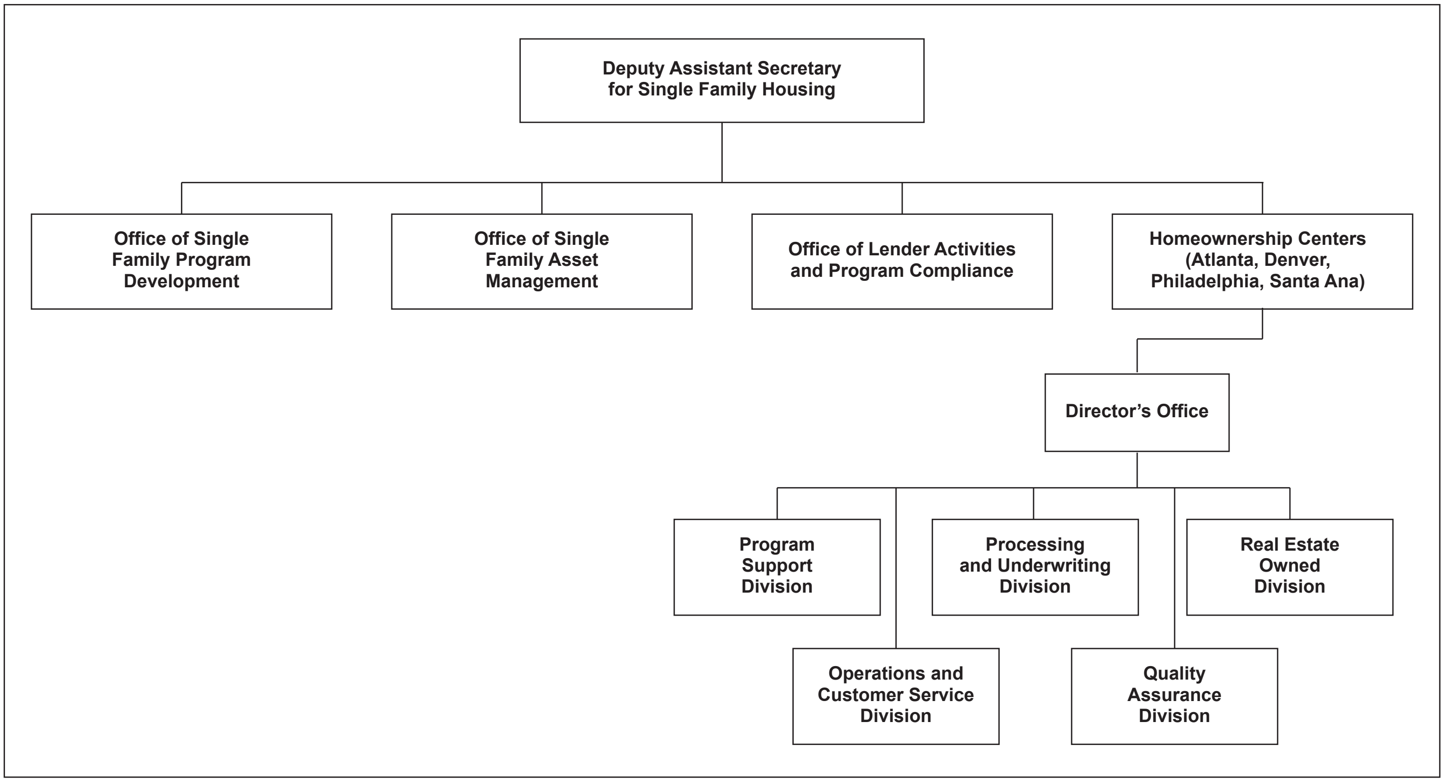
As of September 2011, almost 3,700 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes. Virtually all of these lending institutions have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review.[5] Although they can make underwriting decisions without HUD's prior review, direct endorsement lenders are still subject to a HUD review of loan paperwork prior to endorsement as well as a post-endorsement review of the loan. They can apply to participate in the Lender Insurance program, which enables high-performing lenders to approve mortgages for FHA insurance without a pre-endorsement review by HUD. As of

[5]Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan. Prior to January 1, 2011, about 13,000 lending institutions were approved to participate in FHA's single-family mortgage insurance programs. At that time, FHA stopped allowing loan correspondents to participate in FHA programs. Loan correspondents were lenders that originated FHA-insured loans—meaning that they could accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process—but did not have direct endorsement authority.

September 2011, about 20 percent of direct endorsement lenders participated in the Lender Insurance program. In 2010, these lenders accounted for about 73 percent of FHA's single-family loans.

FHA's single-family insurance programs are administered by the Deputy Assistant Secretary for Single Family Housing (see fig. 1), who reports to the Assistant Secretary for Housing-Federal Housing Commissioner. Within the Office of Single Family Housing, three offices develop policy and manage oversight functions: Program Development, Asset Management, and Lender Activities and Program Compliance. Program Development is responsible for developing policies, procedures, and guidance for lenders that originate and underwrite FHA insured single-family mortgages; administering FHA's housing counseling program; and establishing protocols for property appraisals. Asset Management is responsible for policies and procedures relating to servicing of FHA-insured mortgages from the point of loan insurance until loan payoff or disposition, helping homeowners overcome financial difficulties that lead to mortgage delinquency (loss mitigation), and managing and selling real estate-owned properties (that is, acquired by FHA through the foreclosure process). It includes the National Servicing Center, which implements many of these policies and procedures. Lender Activities and Program Compliance's three divisions oversee lenders and carry out enforcement activities. Specifically, the Lender Approval and Recertification Division approves and recertifies qualified lenders to originate, purchase, or service FHA-insured mortgages. The Quality Assurance Division assesses lender performance, internal controls, and compliance with FHA origination and servicing requirements through on-site reviews, off-site evaluations, and electronic monitoring tools. Finally, the Mortgagee Review Board Division—which serves as staff for the Mortgagee Review Board—pursues administrative actions and sanctions against lenders and related parties that violate FHA requirements. The Mortgagee Review Board takes administrative action against FHA-approved lenders that are not in compliance with FHA lending requirements.

Figure 1: Office of Single Family Housing Organizational Chart



Source: FHA.

FHA's four homeownership centers, in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California, undertake many of the day-to-day functions associated with loan endorsement, processing, and lender oversight. For example, the homeownership centers endorse loans for FHA insurance and oversee lenders and appraisers. As shown in table 1, each homeownership center is divided into five divisions.

Table 1: Homeownership Center Divisions and Responsibilities

Division	Responsibilities
Processing and Underwriting (PUD)	Processes requests for FHA mortgage insurance and oversees lenders and appraisers
Real Estate Owned (REO)	Oversees the management and marketing of homes acquired through foreclosure
Quality Assurance (QAD)	Monitors mortgage lenders
Program Support (PSD)	Performs an array of technical services, including (1) approving and monitoring housing counseling agencies and nonprofit organizations and (2) providing training
Operations and Customer Service (OCSD)	Provides internal operational support for the other divisions and customer service to lenders and the public

Source: FHA documents.

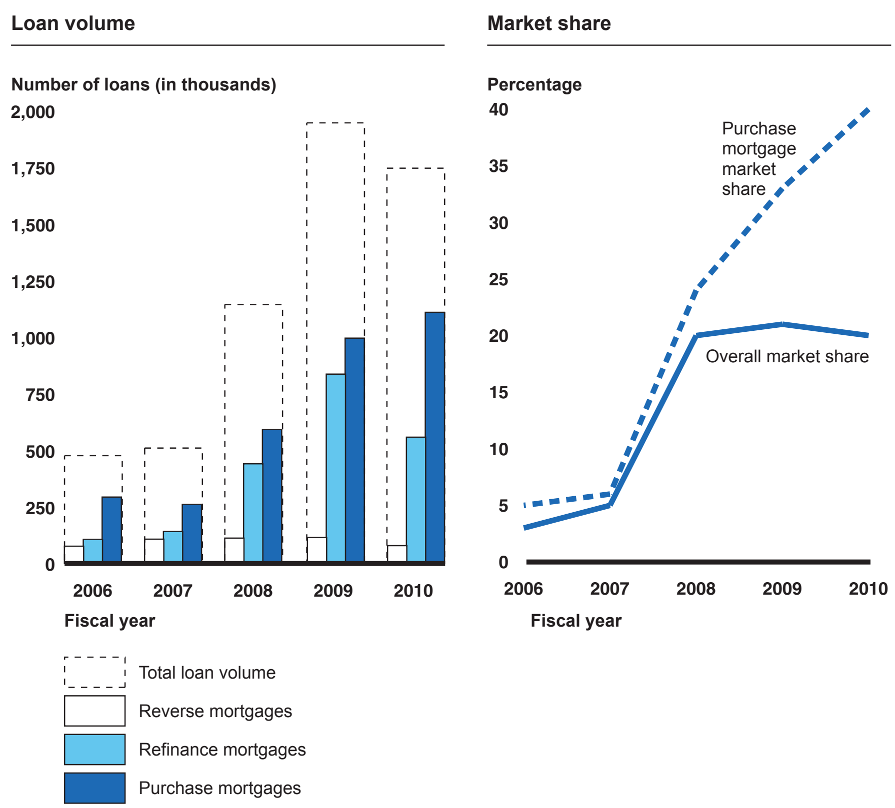
FHA Business Volume and Workload Increased at a Greater Rate than Staffing Levels

FHA's loan volume and the number of lenders and appraisers participating in its programs grew significantly from 2006 to 2010. During the same time period, Single Family Housing field staffing levels remained relatively constant, while key workload items such as volume-driven loan reviews and the management of foreclosed homes grew considerably. Although FHA has taken a number of steps to address its increased workload, it is too soon to determine the effectiveness of these process changes.

FHA's Business Volume, Market Share, and Program Participants Increased Dramatically in Recent Years

FHA's loan volume and market share grew considerably from 2006 to 2010, as did the number of lenders and appraisers participating in its programs. FHA insured almost half a million loans, totaling $70 billion in mortgage insurance, in 2006. For 2009, the agency insured about 1.9 million loans, totaling more than $350 billion in mortgage insurance. The number of loans dropped slightly in 2010 to over 1.7 million, or about $319 billion in mortgage insurance. The drop in overall volume in 2010 largely reflected a decrease in the number of refinance and reverse mortgages FHA insured. However, the number of home purchase mortgages that FHA insured continued to grow, as shown in figure 2. The growth in loan volume in this period resulted from the sharp contraction of other segments of the mortgage market and increases in the loan amounts eligible for FHA insurance.[6] FHA's business volume continued to be high in 2011. As of August 31, 2011, it had insured about 1.2 million loans.

Figure 2: FHA Loan Volume and Market Share, 2006–2010



Source: GAO analysis of FHA data.

FHA's overall market share followed a similar trend as loan volume, increasing from 3.3 percent in 2006 to 19.9 percent in 2010, as the private mortgage market contracted.[7] Additionally, FHA's market share of purchase mortgages increased from 4.5 percent in 2006 to 40.2 percent in 2010.

[6] See GAO-10-827R.

[7] The market share data do not include reverse mortgages.

Lender and, particularly, appraiser numbers also jumped during the same period. The total number of FHA-approved lenders increased 24 percent, from 10,370 in 2006 to 12,844 in 2010. The number of FHA-approved appraisers increased approximately 67 percent from 33,553 in 2006 to 56,192 in 2010. FHA attributes these increases to the growth in its share of the mortgage market.

FHA's Field Staffing Levels Remained Relatively Constant, while Key Workload Items Increased Significantly

Overall, FHA's single-family staff increased 8 percent, from 932 employees in 2006 to 1,011 employees in 2010, while increases in key workload areas often surpassed 100 percent over that period. Homeownership center staff in the field—which account for almost 80 percent of the single-family workforce and conduct most of the day-to-day functions for the Office of Single Family Housing—increased about 4 percent, from 769 employees in 2006 to 799 employees in 2010. At the four homeownership centers, the divisions responsible for key functions include PUD (loan and appraisal reviews), REO (management and marketing of foreclosed properties), and QAD (annual lender reviews). Single-family headquarters staff—who are responsible for policy development and oversight—increased 30 percent, from 163 in 2006 to 212 in 2010. Much of the staffing growth in headquarters derived from enlarging the Deputy Assistant Secretary's office from 12 employees in 2009 to 31 employees in 2010.[8] See table 2 for more information.

[8]According to FHA officials, 18 employees assigned to the Office of the Deputy Assistant Secretary for Single Family Housing were actually located in the field.

Table 2: Single Family Housing Staff Levels, 2006–2010

	2006	2007	2008	2009	2010	Percentage change from 2006 to 2010
Single Family Housing total	**932**	**896**	**942**	**937**	**1,011**	**8**
Headquarters total (including the National Servicing Center)	163	162	145	157	212	30
Homeownership center total	769	734	797	780	799	4
Homeownership center divisions						
PUD	217	203	250	270	265	22
REO	143	144	165	158	162	13
QAD	133	125	113	111	135	2
PSD	200	202	204	182	175	-13
OCSD	48	39	43	41	41	-15
Director's Office	28	21	22	18	21	-25

Source: FHA.

Loan and Appraisal Reviews

PUD staff levels grew at a slower rate (22 percent) than key workload items, particularly volume-driven loan reviews (which increased by more than 100 percent). PUD staff conduct a variety of oversight functions that include technical reviews of loan underwriting quality, evaluation of loans from lenders seeking direct endorsement authority, and reviews of appraisers. PUD staff levels increased 22 percent, from 217 in 2006 to 265 in 2010. In addition to relying on these staff, PUD relied on contractors to assist with loan and appraiser reviews. FHA estimates that contractor full-time equivalents (FTE) devoted to PUD activities increased 66 percent, from 89 FTEs in 2006 to 148 FTEs in 2010.[9] The contract for loan reviews was not renewed in 2011, reducing the number of contractor staff available to assist with these reviews.

The number of post-endorsement technical reviews (PETR) that PUD conducted more than doubled, from 40,373 in 2006 to a peak of 102,000 in 2009 before falling to 85,669 in 2010. These desk audits constitute a primary lender oversight function by evaluating the underwriting quality of

[9]The contractor FTE data presented here (and throughout the report) are a head count of contractor employees for 2010 and estimates for 2006–2009 (based on the 2010 data).

a selection of individual loans already insured by FHA.[10] Reviews revealing serious deficiencies may result in HUD requiring the lenders to compensate the department for financial losses, known as indemnification.[11] FHA met its goal of conducting PETRs on at least 5 percent of insured loans each year from 2006 to 2010 (see fig. 3), although the percentage of loans reviewed declined over time. Indemnification agreements as a result of PETRs decreased from 293 in 2006 to 66 in 2008 before increasing to 645 in 2010. Less than 1 percent of PETRs conducted each year resulted in an indemnification agreement.

Figure 3: Number and Results of Post-endorsement Technical Reviews, 2006–2010

	PETRs conducted	Percentage of endorsements reviewed through PETR (¦ = annual goal)	Indemnification agreements
2006	40,373	9 %	293
2007	36,218	7	112
2008	66,531	6	66
2009	102,000	5	283
2010	85,669	5	645

Source: GAO analysis of FHA data.

In 2010, PUD performed significantly more evaluations of individual loans from lenders seeking direct endorsement authority than it performed in 2006. Lenders seeking such authority must submit 15 acceptable test cases in a 12-month period. Lenders may submit up to 30 loans while seeking to meet the threshold of 15 acceptable test cases. The number of loans reviewed through this approval process increased almost 500 percent, from 1,472 in 2006 to 8,736 in 2009, before dropping to 6,381 in 2010. The number of approved direct endorsement lenders grew by about 500, from 3,095 in 2006 to 3,598 in 2010.

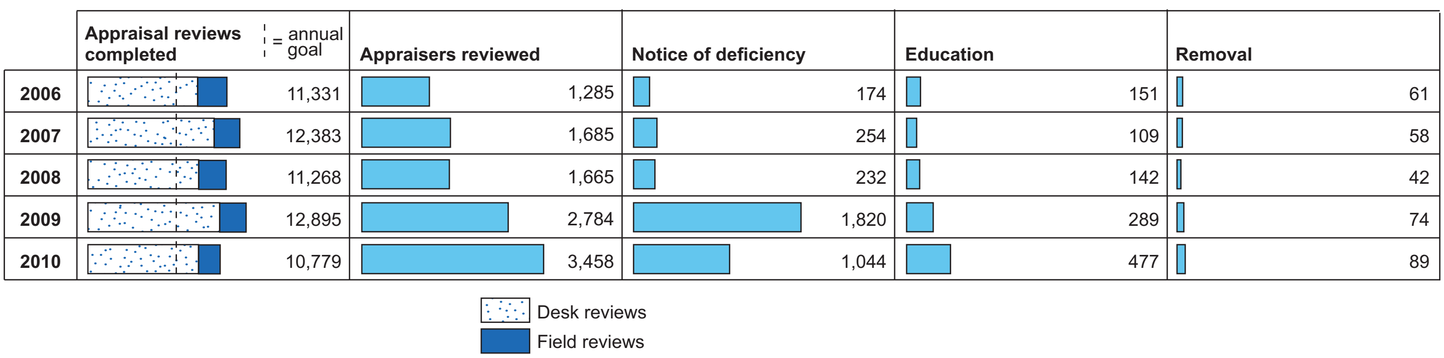
In contrast, PUD workload for appraisal reviews varied little, even though the number of FHA-approved appraisers increased by nearly 70 percent.

[10]Reviewers evaluate the quality of the mortgage credit evaluation of the borrower and the valuation of the mortgaged property.

[11]Indemnification agreements require the lender to repay FHA for any losses that it incurs after a loan has gone into default and the property has been sold.

The appraiser reviews consist of desk reviews (analyses of appraisal reports for completeness, compliance, and reasonable and logical conclusions of property value) and additional field reviews (comprehensive inspections of appraised properties intended to assess the quality of appraisal reports). From 2006 to 2010, staff conducted between 8,900 and 11,000 desk reviews, meeting their goal of reviewing at least 7,200 appraisals annually.[12] Additionally, PUD conducted between 1,700 and 2,400 field reviews each year. PUD addressed the increase in appraiser participation by reducing the number of appraisals reviewed per appraiser. This allowed FHA to review a greater number of appraisers, while the number of appraisal reviews completed remained fairly stable from 2006 to 2010. For example, the number of appraisers reviewed each year increased from 1,285 in 2006 to 3,458 in 2010. Appraiser reviews may result in a variety of actions, ranging from removal from FHA programs to required education to notices of deficiency for minor processing errors (see fig. 4).

Figure 4: Number and Results of Appraisal and Appraiser Reviews, 2006–2010



Source: GAO analysis of FHA data.

PUD staff undertook 5,016 actions against appraisers from 2006 to 2010. Annual appraiser actions increased from 386 in 2006 to 1,610 in 2010. The majority, 70 percent, were notices of deficiency, which have little potential to affect value estimates. Another 23 percent of actions required FHA-approved appraisers to complete education before conducting

[12] FHA's goal specifically refers to the number of appraisals reviewed, not to the number of appraisers reviewed.

additional FHA appraisals. The remaining 6 percent of actions resulted in removal of 324 appraisers from participation in FHA programs.[13]

Foreclosed Property Management

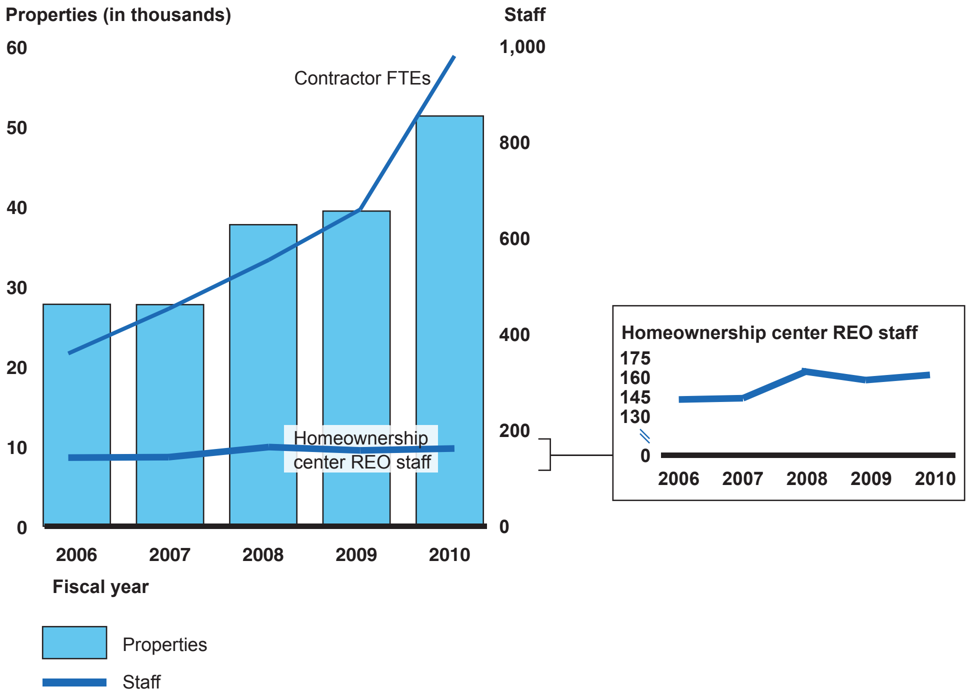
Increases in contractor staff and workload related to management of foreclosed or real estate-owned properties were substantial, but noncontractor staff levels increased at more modest levels. FHA uses contractors to dispose of foreclosed properties through its management and marketing program.[14] Management and marketing contract functions include conducting property inspections, performing cosmetic enhancements and other ongoing maintenance, and marketing properties. FHA's inventory of properties increased 85 percent, from 27,747 active properties at the end of 2006 to 51,292 properties at the end of 2010 (see fig. 5). To manage the additional properties, contractor FTEs nearly tripled from 360 in 2006 to 980 in 2010. FHA also increased the total number of management and marketing contracts from 24 to 55 in 2010, as a result of a significant change in the structure of these contracts. Before 2010, the program operated through 24 geographic areas, with one contractor responsible for all management and marketing functions in an area. In 2010, FHA consolidated the 24 areas into 10 and assigned multiple contractors to an area, with each responsible for a particular function.[15] This resulted in 55 management and marketing contracts. If a contractor does not perform to expectation, other contractors are available to take over the work.

[13]The percentages do not add to 100 percent because of rounding.

[14]The lenders deed the foreclosed homes to the Secretary of HUD in exchange for an insurance claim payment, and the contractors then manage and market the foreclosed (single-family) properties.

[15]FHA awarded contracts for (1) a mortgagee compliance manager, who performs services such as reviewing property inspections and providing guidance to lenders; (2) field service managers, which are companies that provide property preservation and protection services such as inspecting the property, securing the property, performing cosmetic enhancements, and providing ongoing maintenance; and (3) asset managers, who are responsible for the marketing and sale of real estate-owned property.

Figure 5: Active Real Estate-Owned Property Inventory and REO Staff, 2006–2010



Source: GAO analysis of FHA data.

Note: The contractor FTE data provided by FHA were a head count of contractor employees for 2010 and estimates for 2006–2009 (based on the 2010 data).

In contrast, noncontractor REO staff at the homeownership centers increased 13 percent, from 143 employees in 2006 to 162 in 2010. These employees oversee the management and marketing contracts. A 2009 Resource Estimation and Allocation Process (REAP) study stated that REO workload would increase because the staff would have to monitor more contracts than the previous 24 and the division would require additional staff to manage the workload.[16] As a result, it recommended 177 FTEs for REO. As of May 2011, REO had 158 FTEs.

[16]REAP studies establish a staffing baseline for budget formulation and execution, strategic planning, organizational and management analyses, and ongoing management of staff resources.

Loss Mitigation Actions

Loss mitigation actions more than doubled from 2006 to 2010, while loss mitigation staff levels have remained relatively constant. At FHA's National Servicing Center, which is responsible for overseeing lenders' servicing of FHA mortgages and loss prevention, staff levels dropped from 46 in 2006 to 37 in 2008 before rising to 44 in 2010. As shown in table 3, loss mitigation actions more than doubled, from 80,772 in 2006 to 199,223 in 2010.[17] The vast majority of these actions, 94 percent, were focused on home retention, which includes special forbearances, partial claims, and loan modifications. Special forbearance is a payment plan that allows the lender to accept less than the total delinquency due. Through partial claims, FHA advances funds to the lender on behalf of the borrower to cure a default, and the amount of the partial claim is due when the borrower sells the property or the mortgage is paid in full. Loan modifications, FHA's most utilized loss mitigation tool, are permanent changes to one or more terms of the loan that result in a payment that the borrower can afford.

Table 3: Loss Mitigation Actions, 2006–2010

Actions	2006	2007	2008	2009	2010
Special forbearance	20,666	23,912	22,144	20,713	16,602
Partial claim	16,354	15,711	16,416	22,812	15,754
Loan modification	38,508	46,904	57,922	83,609	150,612
Total home retention	**75,528**	**86,527**	**96,482**	**127,134**	**182,968**
Preforeclosure sale	4,909	4,026	4,071	6,474	15,291
Deed-in-lieu of foreclosure	335	454	614	936	964
Total nonretention	**5,244**	**4,480**	**4,685**	**7,410**	**16,255**
Total actions	**80,772**	**91,007**	**101,167**	**134,544**	**199,223**

Source: FHA.

If a borrower does not qualify for home retention, FHA also uses nonretention actions, which consist of preforeclosure sales, or short sales, and a deed-in-lieu of foreclosure. A short sale allows borrowers to sell their houses for less than the outstanding debt. Through a deed-in-lieu of foreclosure, borrowers voluntarily transfer a property to the mortgagee.

[17]Loss mitigation actions seek to minimize losses from potential foreclosures by finding alternatives to foreclosure and helping homeowners retain their homes, if possible.

Annual Lender Reviews

Staffing levels for monitoring approved lenders remained relatively constant in 2006–2010, as did the number of loans reviewed. Lender reviews typically involve an in-depth analysis of a sample of loans and on-site visits to assess lenders' internal control processes for making loans. These reviews are meant to help ensure compliance with FHA standards and provide feedback to lenders to improve their performance. QAD staff at each homeownership center schedule and perform these reviews. QAD staff levels fell from 133 in 2006 to 111 in 2009, before increasing to 135 in 2010.

Although the number of lenders grew, FHA's review of individual loans as part of its annual reviews of lenders' operations remained somewhat constant from 2006 to 2010.[18] The number of loans reviewed (the most direct metric of lender review workload) fluctuated between 13,500 and 16,600 annually. FHA sets an annual goal for lender reviews of 10 percent of active lenders; therefore, the number of lender reviews conducted each year varies.[19] As shown in figure 6, FHA exceeded its goal for lender reviews each year from 2006 to 2010. For example, in 2010 FHA exceed its goal of 300 reviews by completing 327 reviews.

Figure 6: Number and Results of Lender and Loan Reviews, 2006–2010

	Lender reviews					
	Annual goal	Completed[a]	Loans reviewed	Indemnifications	Limited denial of participation	Referrals[b]
2006	500	561	16,131	858	4	523
2007	360	368	13,524	407	3	602
2008	300	313	16,567	232	8	1,032
2009	300	302	15,647	397	4	1,585
2010	300	327	13,709	702	19	1,637

Source: GAO analysis of FHA data.

[a]In 2006, FHA counted lender reviews at subsidiary branches of larger institutions as additional reviews. Starting in 2007, lender reviews conducted at subsidiary branches of a larger lending institution were not counted as separate lender reviews.

[b]Referrals include cases that are referred to the Mortgagee Review Board, the HUD Inspector General, or other entities such as state regulatory agencies.

[18]FHA selects lenders for review using a risk-based approach. We will discuss this selection process in more detail later in this report.

[19]Active lenders are those that have at least one loan underwritten or in their servicing portfolio as of July 31 of the prior fiscal year.

FHA can take a variety of administrative actions as a result of lender reviews, such as denying participation in FHA programs or referring cases containing material violations to the Mortgagee Review Board, cases of fraud to the HUD Inspector General (IG), or cases to other entities such as state regulatory agencies. If a lender review found serious deficiencies with specific loans or the lender's internal controls, FHA could require indemnification agreements of lenders. The number of indemnification agreements FHA reached annually as a result of lender reviews dropped from 858 in 2006 to 232 in 2008 before increasing to 702 in 2010. The number of lenders denied participation in FHA programs, or given a limited denial of participation, increased from 4 lenders in 2006 to 19 lenders in 2010. Additionally, FHA referrals to the Mortgagee Review Board, the HUD Inspector General, or other entities as a result of lender reviews increased from 523 in 2006 to 1,637 in 2010. According to FHA officials, the number of referrals increased because, among other things, guidance changes emphasized HUD's requirement that lenders report findings of fraud or other serious violations to FHA and there has been continued emphasis on lender reporting requirements during QAD reviews of lenders.

Data on how FHA's workload and staffing have affected its capacity are limited. In 2008, FHA hired consultants to, among other things, examine process constraints related to Single Family Housing's capacity to process increasing workloads.[20] The study indicated that processes supported by the homeownership centers from June 1, 2008, through December 6, 2008, exceeded capacity because of a lack of staff. For example, the time to process applications increased during this period, as did the backlog of PETRs. The study noted that historical data needed to conduct additional analyses were not available. Although its loan volume has declined somewhat from its peak in 2009, FHA has made changes to its work processes to accommodate its increased workload. We discuss these changes, their potential advantages and disadvantages, and additional human capital challenges later in this report. However, it is too soon to determine how effective process changes will be in managing FHA's increased workload.

[20]G&B Solutions and KPMG, *Risk Capacity Study, Single Family Housing Application and Endorsement Processes*, a report prepared at the request of the Department of Housing and Urban Development, Feb. 2, 2009.

FHA Has Yet to Implement a Comprehensive Risk Assessment Strategy

Although FHA has taken steps to assess credit and operational risks facing its single-family insurance programs, its current risk assessment strategy is not comprehensive because it is not integrated across the agency and lacks annual assessments and mechanisms to anticipate changing conditions. FHA established a risk office and hired a consultant to help the office develop a strategy for identifying and addressing risks. However, implementation of the consultant's recommendations has been slow because of delays in defining the new office's authority, difficulty filling new staff positions, and changes in FHA leadership.

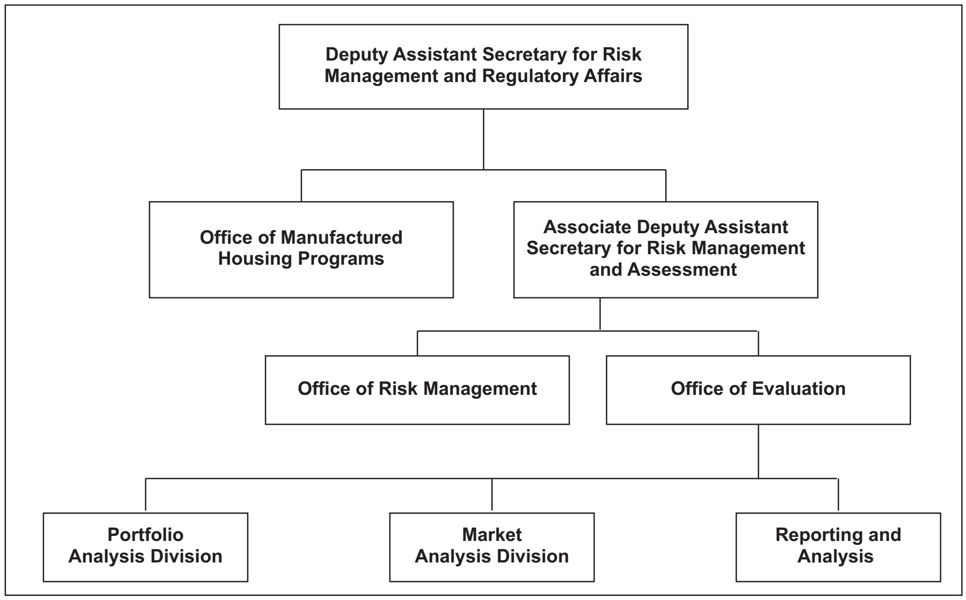
FHA Established a Risk Office, Added Management Controls, and Undertook Other Efforts to Assess Risks

To improve its risk assessment strategy, FHA established a risk office, implemented a new system of management control in the Office of Single Family Housing, and undertook studies to identify and address risks related to the rapid increase in single-family business volume.[21] In 2010, FHA received congressional approval to establish the Office of Risk Management and Regulatory Affairs and create the position of Deputy Assistant Secretary for Risk Management and Regulatory Affairs (see fig. 7), which reports directly to the Assistant Secretary for Housing-FHA Commissioner. The new office functions within the Office of Housing to assess and manage risks in three program areas: single-family housing, multifamily housing, and health care. Within the Office of Risk Management and Regulatory Affairs, risk assessment and management functions reside in two offices: the already existing Office of Evaluation (with approximately 25–30 staff) and the newly established Office of Risk Management (ORM). When FHA reorganized in 2010, it moved the Office of Evaluation into the Office of Risk Management and Regulatory Affairs. Among other functions, the Office of Evaluation oversees the annual independent actuarial studies that determine the net worth of the insurance fund and conducts ongoing portfolio analyses designed to assess risks to the insurance fund. The actuarial studies forecast the effect that various economic risks will have on the fund, including alternative scenarios for volatile interest rates and recoveries and recessions of various degrees. The Office of Evaluation also performs ongoing and in-depth analyses to determine the effects various risk

[21] According to our internal control standards, risk assessment is the identification and analysis of risks. See GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

factors, including those identified by the annual actuarial review, have had and likely would continue to have on the portfolio.[22]

Figure 7: Organizational Chart for FHA's Office of Risk Management and Regulatory Affairs, as of August 2011



Source: FHA.

To provide assistance to ORM in developing a risk management strategy and organizational structure and establishing risk management policies and processes, FHA hired a consultant to produce a comprehensive report and recommend best practices for its operation. The consultant's December 2010 report outlined a consolidated framework for the risk assessment activities carried out in different parts of the organization.[23] The study also provided a strategy for classifying, assessing, and mitigating risk; options for organizational design and governance; options

[22]See GAO-10-827R for a discussion of the results of the independent actuarial report and some of the risk analyses the Office of Evaluation conducted (related to the credit quality of loans, trends in delinquency rates, and policy changes, such as in insurance premiums and underwriting).

[23]McKinsey & Company, *Building the ORM Organization, Close-out Materials*, a report prepared at the request of the Department of Housing and Urban Development, December 2010.

and recommendations for improvements to key risk processes and reporting; and a timeline for implementing changes. Regarding the options for organizational design, the study recommended a risk officer for each of the three program areas (single-family housing, multifamily housing, and health care) and for operations. Regarding the options for governance, the consultants recommended that FHA establish charters for the following committees: Enterprise (or overall) Risk Management Committee, Single Family Credit Risk Committee, Multifamily Credit Risk Committee, Health Care Risk Committee, and Operational Risk Committee. The charters would identify the issues each committee would address, how (such as by majority vote) and to which manager it would make its recommendations, the composition of committee members, and the frequency of meetings. For example, the Enterprise Risk Management Committee would meet quarterly to address, among other things, agencywide risk issues, such as those related to its mission and the balancing of risks. The FHA Commissioner or the Deputy Assistant Secretary for Risk Management and Regulatory Affairs would make decisions related to these issues, the Deputy Assistant Secretary for Risk Management and Regulatory Affairs would be the committee chair, and the FHA Commissioner and all deputy assistant secretaries would be standing committee members. According to FHA officials, FHA plans to adopt the consultant's recommendation to establish a two-tiered structure, with an enterprise risk committee to address overall risk to the organization and a second tier of committees to address program and operational risks. As discussed later in this report, the risk committees and ORM's operational procedures remain under development.

In addition to commissioning the recent study, FHA had undertaken other efforts to assess risks in its single-family programs. For instance, in 2009 Single Family Housing implemented a new system of management control for risk assessment, the internal quality control initiative, at headquarters and the four homeownership centers. Although the implementation was the result of an ongoing improvement effort, it was also intended to address a 2008 HUD IG audit report finding that Single Family Housing had not complied with our internal control standards and

HUD Handbook 1840.1 requirements.[24] Among other requirements, our internal control standards state that management must comprehensively identify risks, analyze them for possible effects, and determine what actions should be taken to manage risks. The HUD handbook specifies that HUD managers should assign individual programs and administrative functions an annual risk rating of low, medium, or high, using a HUD risk assessment worksheet. To comply with the handbook requirements as the IG had recommended, Single Family Housing completed its initial assessment of risks by April 2009. On the basis of this analysis, most of the functional areas in headquarters and the homeownership divisions were scored as high-risk. For example, PUD, PSD, and REO at the homeownership centers were considered high-risk. For the areas identified, headquarters and the homeownership center divisions developed internal quality control plans to document control objectives and established a monitoring strategy that requires each homeownership center to submit quarterly reports to the Deputy Assistant Secretary's office at headquarters on the effectiveness of these controls, including the status of any mitigation efforts. Quarterly, the homeownership centers review multiple control processes in each of their divisions. For example, in 2010 one homeownership center reviewed a total of 26 processes in five divisions, including PUD processes for evaluations of loans from lenders seeking direct endorsement authority, PETRs, loan endorsements, appraiser reviews, and contract/contractor monitoring.

Other efforts in 2008 and 2009 helped identify and address risks related to the rapid increase in single-family business volume:

- As noted previously, in 2008 FHA hired a consultant to examine technology and process constraints and identify the risks related to Single Family Housing's capacity to process increasing workloads (that is, the increased number of insurance endorsements and lenders applying to participate in the program) as the program grew dramatically.[25]

[24]See Department of Housing and Urban Development, Office of the Inspector General, *HUD's Office of Single Family Housing Had Not Fully Implemented an Internal Control Structure in Accordance with Requirements*, Audit Report 2008-KC-0006 (Washington, D.C.: Sept. 8, 2008); GAO/AIMD-00-21.3.1; and Department of Housing and Urban Development, Office of the Chief Financial Officer, *Departmental Management Control Program*, Handbook 1840.1 Rev-3 (Washington, D.C.: 1999).

[25]*Risk Capacity Study, Single Family Housing Application and Endorsement Processes*.

- Single Family Housing requested that HUD conduct a REAP study, which was completed in 2009, because of unprecedented increases in workload and the need to assess the resources needed to address the sharp increase in business volume.[26] The purpose of HUD's REAP studies is to help determine proper staffing levels within each HUD program office.
- Also in 2009, FHA conducted an internal study that assessed its information technology weaknesses and proposed an approach to address its information system constraints.[27]

(We discuss the results of these reports in more detail later in this report.) These reports, along with the consultant's 2010 report on ORM, identified specific credit and operational risks for the single-family insurance programs (see table 4).

Table 4: Credit and Operational Risks That FHA Identified in Its Single-Family Insurance Programs

Credit risk	
Subcategory	**Description**
Borrower default risk	Risks related to rising delinquencies and defaults and the need to respond with aggressive loss mitigation interventions
Counterparty risk	Risks associated with lenders and appraisers related to deficient lender practices and the quality and uncertainty of appraisals
Operational risk	
Subcategory	**Description**
Human capital risk	Risks related to staffing and contractor capacity to process increasing workloads
Information technology risk	Risks related to FHA's aging and outdated information technology

Source: GAO analysis of the ORM consultant's report, 2009 risk capacity study, 2009 REAP study, and 2009 information technology improvement plan.

[26]Department of Housing and Urban Development, *Resource Estimation and Allocation Process (REAP), Office of Housing, DAS for Single Family Housing, Study #1: Office of Single Family Housing–Field* (Washington, D.C.: September 2009).

[27]Department of Housing and Urban Development, *FHA Office of Housing Information Technology Strategy and Improvement Plan* (Washington, D.C.: Aug. 13, 2009).

FHA's Current Strategy Is Not Integrated across the Agency and Lacks Annual Assessments and Mechanisms to Anticipate Changing Conditions

FHA's current risk assessment strategy is not comprehensive because it is not integrated throughout the organization, certain aspects are not updated annually as required, and it lacks specific mechanisms—such as a reporting process for identifying emerging risks—to anticipate risk presented by changing conditions. According to our internal control guidance, an agency should have an integrated management strategy and risk assessment plan that considers the entitywide objectives and relevant sources of risk from internal management factors and external sources, and establishes a control structure to address those risks.[28] However, while the ORM consultant has recommended that FHA integrate risk assessment and reporting throughout the organization, currently Single Family Housing's quality control activities and ORM's activities remain two separate efforts. For instance, the results of the quarterly quality control activities are not shared outside the Office of Single Family Housing. Although homeownership center officials may have raised some of the issues from the quarterly reports in their regular conferences with the single-family program offices in headquarters, the quarterly reports are not sent to any office outside of Single Family Housing, such as ORM. Further, what actions headquarters has taken based on the risk assessments is not clear. Officials at all four homeownership centers told us that they had not received any feedback from headquarters about their quarterly reports. According to ORM officials, FHA intends to integrate the internal quality control initiative implemented by Single Family Housing into ORM's new strategy. The ORM consultant's report recommended ORM involvement in the monitoring and improvement of internal quality efforts by reviewing and making recommendations related to policy development and the selection of corrective actions. It also recommended that ORM conduct reviews of the program offices' internal quality control efforts. ORM officials told us that the recently hired operational risk officer would review how the quality control initiative should be integrated into ORM's management of operational risk and make recommendations to ORM management. However, FHA officials noted that until ORM set up a governance process, the integration suggested by the consultant would not be possible. In the meantime, they stated that every effort was being made to ensure that ORM's activities were complementary to those of the program offices, including Single Family Housing.

[28] GAO, *Internal Control Management and Evaluation Tool*, GAO-01-1008G (Washington, D.C.: August 2001).

In addition, contrary to HUD guidance, Single Family Housing has not conducted an annual, systematic review of risks to its program and administrative functions. HUD Handbook 1840.1 requires that agencies perform an annual risk assessment of their programs or administrative functions using the HUD risk assessment worksheet. The internal quality control initiative coordinator in the Office of Single Family Housing told us that while headquarters and the field have continued to perform quarterly reviews of their programs to identify and mitigate risks, they had not conducted an annual risk assessment using the HUD worksheet since the initiative was first implemented in 2009. However, the coordinator noted that they were currently in the process of reassessing risks using this worksheet. The coordinator also told us that although management intended to conduct an annual assessment, the dates had slipped because of changes in senior leadership within Single Family Housing, loss of staff who previously performed the assessments, and additional demands on staff—who would otherwise conduct the assessment—from the increased business volume.

Finally, Single Family Housing's current risk assessment efforts do not include procedures for anticipating potential risks presented by changing conditions. Our internal control standards and HUD Handbook 1840.1 require agencies to have mechanisms to identify and address any special risks prompted by changing conditions, such as those presented by rapid growth or downsizing. The internal quality control initiative coordinator told us that the initiative was not designed to include such mechanisms, although the program offices may discuss emerging risks during management meetings and periodic meetings with field staff. The official also stated that the HUD handbook does not provide detailed instructions on what mechanisms should be used. Further, while the consultant's report recommends that ORM conduct analyses related to "enterprise-level risk identification and monitoring," it does not explicitly identify the mechanisms to be used to identify special risks, such as those that might be caused by changing conditions.[29] However, the report proposes a reporting process and formats for identifying emerging risks. It provides specific examples of monthly reports that include a template for reporting on the severity and likelihood of risks and on plans and actions to address major emerging risks. ORM officials told us that the exact design and

[29]The ORM consultant's study relied on ad hoc Commissioner's retreats to identify the greatest risks to each program area.

content of the report formats and templates eventually would be determined by the risk committees, once they have been established and are operational.

Moreover, implementation and integration of the new risk assessment strategy and planned tools has been slow because of delays in defining ORM's authority, difficulty filling new staff positions in ORM, and changes in FHA leadership.

- According to an ORM official, delegations of authority from other offices within FHA are needed before ORM can become fully operational. After the consultant made its recommendations, ORM drafted and revised the delegations. As of the end of September 2011, the delegation proposal was still under review. Until the various program offices within the Office of Housing have delegated the necessary authority to ORM, it cannot establish its operational procedures or form the risk committees to formally carry out its risk management function. In the interim, ORM officials stated they have been meeting informally with program staff to discuss risks.

- According to FHA officials, implementation of ORM strategies has been constrained largely as a result of difficulties in hiring qualified staff and matching industry salaries.

- Finally, the recent departures of FHA's top leadership have made obtaining management "buy-in" to establish operational authorities and procedures difficult for ORM, which has delayed implementation of the new risk assessment strategy. In 2011, both the Assistant Secretary for Housing-Federal Housing Commissioner and the Deputy Assistant Secretary for Single Family Housing left FHA, and the Deputy Assistant Secretary for Risk Management and Regulatory Affairs became the acting FHA Commissioner (see table 5). More recently, the acting FHA Commissioner left FHA to become an adviser to the Secretary of HUD, and the former Deputy Assistant Secretary for Multifamily Housing became the acting FHA Commissioner. Also, the Office of Single Family Housing is headed by an Acting Deputy Assistant Secretary. According to ORM officials, management decisions are required to implement many of the key changes, and having frequent changes and temporary incumbents in leadership positions hampers FHA's progress.

Table 5: Status of Key Leadership Positions Involved in Implementing FHA's New Risk Assessment Strategy, as of September 2011

Position	Status
Assistant Secretary for Housing-Federal Housing Commissioner	Acting
Deputy Assistant Secretary for Risk Management and Regulatory Affairs	Acting
Deputy Assistant Secretary for Single Family Housing	Acting
Deputy Assistant Secretary for Multifamily Housing	Acting
Deputy Assistant Secretary for Healthcare Programs	Permanent

Source: FHA organizational chart and officials.

All of these factors limit FHA's effectiveness in identifying, planning for, and addressing risk. More specifically,

- without an integrated risk assessment strategy, certain risks may not be fully addressed at the operational level in a way that minimizes risk to the insurance programs;
- without annual reassessments of its risks, Single Family Housing lacks assurance that its quality control efforts are addressing all of its risks; and
- without ongoing mechanisms in place to anticipate and address new or emerging risks, FHA lacks a systematic approach to help the agency identify, analyze, and formulate timely plans to respond most effectively to changed conditions and risks.

Although FHA Has Enhanced Risk Management and Plans to Modernize Information Technology, Human Capital Challenges Remain

FHA has taken steps to address risks to its single-family programs, such as credit risk and risks associated with lenders and appraisers. It also has made plans to address risks related to its information technology. However, it does not have a strategic process for determining its future workforce needs, including succession planning.

FHA Has Made or Proposed Enhancements to Address Credit and Counterparty Risk

As we previously reported, to help improve the financial condition of the Fund (which is supported by borrower premiums), FHA raised premiums and made or proposed policy or underwriting changes to address credit risk.[30] For example, in April 2011 FHA increased its annual insurance premiums from 0.85 percent to 1.10 percent for borrowers with 30-year loans with initial LTV ratios of 95 percent or less and from 0.90 percent to 1.15 percent for borrowers with 30-year loans with initial LTV ratios greater than 95 percent. Additionally, FHA increased down payment requirements for borrowers with lower credit scores. More specifically, the agency required a down payment of at least 10 percent for borrowers with credit scores of 500-579, and made anyone whose credit score was below 500 ineligible for FHA-insured loans.[31] FHA also has proposed reducing allowable seller contributions at closing, thereby helping to ensure that buyers put more of their own funds into the home purchase. In addition, FHA is in the process of revising its mortgage scorecard algorithm, known as the Technology Open to Approved Lenders (TOTAL) to recognize the effect of various risk elements not currently discerned by the scorecard and determine what cases warrant manual underwriting.[32] According to FHA, these revisions are in the early stages, and no completion date has been set.

FHA also has made recent changes to address risks posed by its counterparties (for example, lenders and appraisers) that have advantages and disadvantages for FHA, lenders, or consumers. For example, on May 20, 2010, FHA stopped approving new loan

[30]GAO-10-827R.

[31]Credit scores, which assign a numeric value to a borrower's credit history, have become a popular tool in assessing applications for loans. They are often called FICO scores because most scores are produced with software developed by the Fair Isaac Corporation. FICO scores generally range from 300 to 850, with higher scores indicating better credit history. The lower the credit score, the more compensating factors lenders might require to approve a loan, such as a higher down payment or greater borrower reserves.

[32]The purpose of TOTAL is to objectively measure the borrower's risk of default quickly and efficiently by examining the data the borrower provides on the loan application and the borrower's credit score.

correspondents to participate in FHA programs.[33] As of January 1, 2011, existing loan correspondents could no longer participate in FHA programs. Former loan correspondents can now participate in FHA programs only as third-party originators through sponsorship by FHA-approved lenders. According to FHA officials, one advantage of this rule change is that it reduces FHA's workload because the agency no longer has to approve and oversee loan correspondents. Prior to January 1, 2011, FHA had around 9,000 loan correspondents; thus, FHA drastically reduced the number of lenders it was responsible for overseeing. With this change, FHA can focus its resources on oversight of lenders that make underwriting decisions. These lenders make decisions on whether or not borrowers qualify for FHA-insured loans; thus, they potentially place FHA at higher risk if they do not properly underwrite these loans. However, this rule change could expose FHA to greater risk if sponsoring lenders do not adequately oversee third-party originators. Therefore, following through and rigorously assessing lenders' monitoring of third parties is important. In January 2011, FHA specified in a mortgagee letter (a written instruction to FHA-approved lenders) that it required sponsoring lenders to take steps to ensure they provide adequate oversight of third-party originators. Specifically, the sponsoring lenders are required to develop a quality control plan that includes procedures for reviewing and monitoring their third-party originators; this plan must be approved by FHA. In addition, FHA has drafted updated guidance for QAD staff on conducting lender reviews to incorporate the evaluation of a sponsoring lender's oversight of its third-party originators. FHA expects the homeownership centers to start implementing the updated guidance by December 2011.

Furthermore, the agency has increased the net worth requirement for approved lenders. On May 20, 2010, FHA increased the net worth requirement for its new lenders from $250,000 to $1 million. On May 20, 2011, FHA increased the net worth requirement for its existing lenders to $1 million, except for lenders classified as small under the Small Business Administration's size standards (their requirement increased to

[33]Loan correspondents were categorized as supervised and nonsupervised correspondents. Supervised loan correspondents were entities such as banks and credit unions that had to have one or more sponsors who underwrote the mortgages. Nonsupervised loan correspondents were nondepository financial entities that had as their principal activity the origination of FHA-insured mortgages for sale or transfer to one or more sponsors who underwrote the mortgages. Sponsors had to be direct endorsement lenders.

$500,000). As of May 20, 2013, FHA will require a net worth of $1 million irrespective of the size of the lender, plus 1 percent of the total loan volume in excess of $25 million, up to a maximum required net worth of $2.5 million.[34] This change is intended to help ensure that FHA-approved lenders are sufficiently capitalized to meet the potential needs associated with the financial services they provide. However, the rule change could disadvantage some program participants or borrowers. First, increasing the net worth requirement to $2.5 million could favor large lenders over smaller ones, including credit unions. According to Independent Community Bankers of America officials, one provision of the rule change requires all lenders to have audited financial statements. These officials stated that the audits are relatively expensive, and it may not make financial sense for small lenders that do not process many FHA loans to continue participating in the program. FHA has partially addressed this concern by issuing a 1-year waiver of the requirement to submit audited financial statements for supervised lenders with less than $500 million in assets.[35] Instead, these lenders must submit an unaudited regulatory report on their financial condition, known as a Report of Condition and Income (or Call Report), that they currently submit to their regulators. However, these lenders are still required to submit an independent auditor's opinion of internal control and compliance with HUD programs. Second, some small lenders have raised concerns that higher requirements would result in lenders passing higher costs on to borrowers, thereby limiting the availability of mortgage credit in small communities and rural areas. When FHA finalized the revised net worth requirements, it stated that the changes were designed to ensure that FHA remains financially stable and strong.

FHA also has made changes to several processes intended to help ensure that lenders and appraisers follow its policies and procedures. For example, FHA enhanced the criteria it uses to select loans for PETRs. Specifically, since May 3, 2010, the agency has considered high-risk loan or borrower characteristics, such as certain types of refinanced loans and loans to borrowers with low credit scores. Additionally, the current

[34]Loan volume is defined as FHA single-family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year.

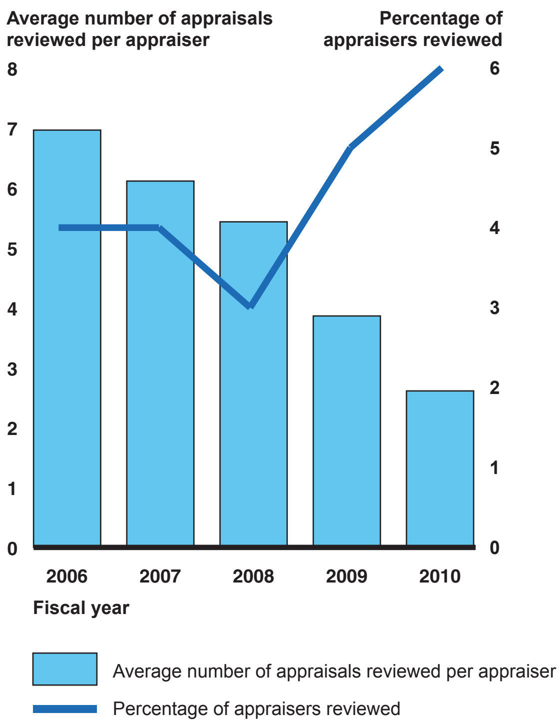
[35]Supervised lenders are those institutions that are regulated by entities such as the Federal Deposit Insurance Corporation or the National Credit Union Administration. This waiver will expire on April 7, 2012, but FHA officials stated that they are taking steps to make this waiver permanent.

selection criteria are heavily weighted toward early payment defaults (loans at least 60 days delinquent in the first six payments). The previous standard for selecting loans subject to PETRs related to lender volume and the goal of reviewing 5–10 percent of FHA's loan volume, according to an FHA official. The agency also introduced a new approach on October 1, 2010, that requires FHA staff to use detailed review sheets to promote more thorough and analytical reviews by FHA underwriters and appraisers. Advantages of the revised approach include that the risk-based selection has resulted in fewer cases for FHA to review, thus decreasing staff workload. As of March 31, 2011, FHA had reviewed 1.4 percent of the loans endorsed during the first 6 months of 2011. However, although FHA has been reviewing fewer loans, FHA officials told us that the loans selected have required in-depth scrutiny because they have one or more issues. In addition, as a result of identifying more problematic loans, staff have been referring a greater proportion of loans to QAD for indemnification.

FHA has made several changes to its approach for conducting lender reviews. First, for 2011, the agency removed originating lenders as a review category, to account for the elimination of loan correspondents effective January 1, 2011. Second, FHA instituted a new methodology that increased the number of risk factors used to target lenders for review. The risk factors included loan volume, product type, process (for example, direct endorsement or lender insurance), performance, and peer group performance. This approach allows FHA to focus its limited resources on lenders posing the highest risk to the program. For 2011, FHA lowered its goal for lender reviews from 300 to 250 lenders. The goal had been 300 for 2008–2010.

Finally, FHA has revised its approach for overseeing appraisers. First, as of March 2010, appraisers were targeted using an algorithm based on nine criteria, which considered factors such as the appraiser's volume and past sanctions, as well as the type of property being appraised. According to FHA officials, the new algorithm has allowed FHA to improve its targeting of potential problem appraisers. Second, once an appraiser has been targeted for review, the targeting program identifies three appraisals to be pulled for review by the homeownership centers. In the past, the program targeted a higher number of appraisals per appraiser. Reducing the number of appraisals per appraiser allowed the agency to review a greater percentage of appraisers as the number of appraisers in the program grew (see fig. 8).

Figure 8: Average Number of Appraisals Reviewed per Appraiser and Percentage of Appraisers Reviewed, 2006–2010



Source: GAO analysis of FHA data.

FHA Recently Started Modernizing Its Information Technology Systems

More than 40 information technology (IT) systems support FHA's single-family insurance programs. The systems are critical to FHA's mission and are used to process loans; monitor lenders and appraisers; manage mortgage billing, collection, and claims services; and report on financial and performance indicators. However, these systems are antiquated and have constraints that make it difficult for the agency to adjust to its current high-volume lending environment. FHA has reported that the IT systems its single-family programs use are outdated, unable to sustain the increasing volume of insurance applications, and costly to maintain. In addition, the agency, HUD's IG, and others have identified several problems with these systems. Specifically,

- major systems operate on mainframe computers that cannot be scaled up easily to meet the performance requirements resulting from FHA's increasing volume of applications;

- system software is antiquated and consequently not easy to upgrade to meet new legislative requirements without significant cost;
- the large number of systems has resulted in hundreds of interfaces—thus, a change in one system requires an extensive effort to ensure that interfaces can be appropriately maintained across systems;
- the multiple systems and interfaces present challenges for maintaining appropriate accessibility levels, security controls, and privacy standards;
- managers do not have the real-time information needed to monitor operational performance, balance workloads, redistribute resources, or evaluate risks; and
- homeownership center staff have had to create manual and offline processes for analysis and reporting and these processes are not necessarily consistent among the centers.

Further, the recent increase in FHA's business volume has exacerbated its IT constraints. For example, the 2009 Risk Capacity Study reported that critical elements of FHA's IT infrastructure were at capacity, causing work slowdowns and poor customer service.[36] This study highlighted significant performance issues such as network overloads that slowed systems in the afternoon, when work hours overlapped at the homeownership centers (which are in different time zones). To partially address these issues, HUD's Office of the Chief Information Officer upgraded the mainframe's system capacity and made changes to certain applications to improve response time and return the system to acceptable performance levels. Nevertheless, FHA had reached the limit of hardware and software capacity on those systems during a period in which transaction levels continued to increase.

To address system constraints, in August 2009 FHA completed a study of strategic IT investments needed to address the agency's business needs and identified five critical initiatives for its single-family insurance programs (see table 6).

[36] *Risk Capacity Study, Single Family Housing Application and Endorsement Processes*.

Table 6: Five Most Critical Information Technology Initiatives for FHA's Single-Family Insurance Programs

Initiative	Description
Automated underwriting system[a]	Implementation of a standard automated underwriting system to evaluate loan applications and associated risk data to determine eligibility for insurance
Automated valuation model	Acquisition of a mathematical model and database that provides automated property valuations to provide more timely and accurate property valuations
Electronic application submission	Ability to electronically generate, transfer, sign, and store documents associated with the mortgage insurance process
Fraud detection and prevention	Acquisition of specialized business intelligence analytics software that would help the agency evaluate whether loan application data included errors or misrepresentation, or might indicate fraud
New infrastructure/replace the Computerized Home Underwriting Management System (CHUMS)	Replace FHA's major underwriting system (CHUMS) with an off-the-shelf system that would enable the agency to decrease its processing times, increase data accuracy, and provide better service to its customers

Source: FHA's Information Technology Strategy and Improvement Plan.

[a]An automated underwriting system allows lenders to enter information on potential borrowers into electronic systems that contain an evaluative formula, or algorithm, called a scorecard. The scorecard uses a variety of variables that include the borrower's characteristics (credit score and cash reserves, for example) and loan characteristics to calculate the applicant's creditworthiness. FHA-approved lenders use automated underwriting systems in conjunction with TOTAL to underwrite FHA-insured loans.

In January 2010, FHA began planning and implementing key aspects of the identified initiatives as part of its FHA Transformation efforts, which HUD initially estimated would cost $281 million over the next 5 years.[37] Specifically, FHA began efforts to detect and prevent fraud, known as the Risk and Fraud Initiative. Under this initiative, FHA will award contracts to (1) install and use business intelligence software to assess counterparty risks; (2) acquire existing analytical tools for collateral risk management,

[37]We recently reviewed HUD's IT expenditure plan, which includes information on FHA's Transformation Initiative. See GAO, *Information Technology: HUD's Expenditure Plan Satisfies Statutory Conditions, and Implementation of Management Controls Is Under Way*, GAO-11-762 (Washington, D.C.: Sept. 7, 2011). The report included a recommendation related to HUD's enterprise architecture.

borrower verification, and fraud detection; and (3) review and assess the revised PETR loan selection criteria.

In addition, the agency began its Infrastructure Transformation Initiative, which is intended to replace CHUMS, the core case management system. In its place, the agency will use the Financial Industry Standard Platform, an off-the-shelf system. The system will allow FHA to implement a "case management" approach for monitoring a loan throughout its life cycle (e.g., initial data submission and approval and servicing of the loan) and utilize risk-related tools to help better understand market trends. Additionally, the system will allow FHA to leverage risk and fraud tools and capture critical data points at the front end of the loan process to help detect risk and prevent fraud.

In February 2011, FHA established milestones of April 2011, October 2011, and April 2012 for various deliverables under the FHA Transformation Initiative. According to project officials, FHA met the deadline for all April 2011 deliverables. Specifically, the agency

- incorporated the initial components of the Financial Industry Services Platform into HUD's IT environment;
- developed an environment in the Financial Industry Services Platform that allows FHA to pilot applications before fully implementing them in the new infrastructure;
- documented requirements via a pilot process for the Financial Industry Services Platform, including future goals and what components would be needed to achieve FHA's business objective;
- acquired the means to migrate existing applications in CHUMS to the Financial Industry Services Platform; and
- enhanced the capability to identify loans for PETR selection and prepare better secondary reviews.

Work continues on deliverables due in October 2011 and April 2012. The deliverables for October 2011 are (1) implementing counterparty risk management solutions in the Financial Industry Services Platform, including a tool to automate lender approval for single-family insurance programs and requirements for the annual recertification of approved lenders; (2) developing a plan for incorporating risk and fraud tools in the Financial Industry Services Platform; and (3) completing migration of one

CHUMS application to the Financial Industry Services Platform. By April 2012, FHA plans to (1) develop portfolio modeling and scenario analysis and (2) increase business control over operational risk and fraud in the pre-endorsement and endorsement processes. As of September 22, 2011, project officials said that FHA is on track to meet these milestones.

FHA has major components to complete. As indicated earlier, one goal of the initiative is to replace CHUMS with the Financial Industry Standard Platform. To meet this goal, FHA will need to migrate functions and applications associated with loan origination and underwriting, business partner (for example, lender) approval and monitoring, and components of loan account servicing and administration. As noted above, FHA expects to have one application in one CHUMS area operating from the new platform by April 2012. To illustrate the amount of work remaining, 5 functional areas and more than 30 subareas under loan origination and underwriting eventually will need to be migrated. In addition to these CHUMS components, several other IT systems will need to move to the new platform. FHA has been defining the steps it plans to take beyond April 2012 to complete its IT modernization and fully realize the benefits of these initiatives.

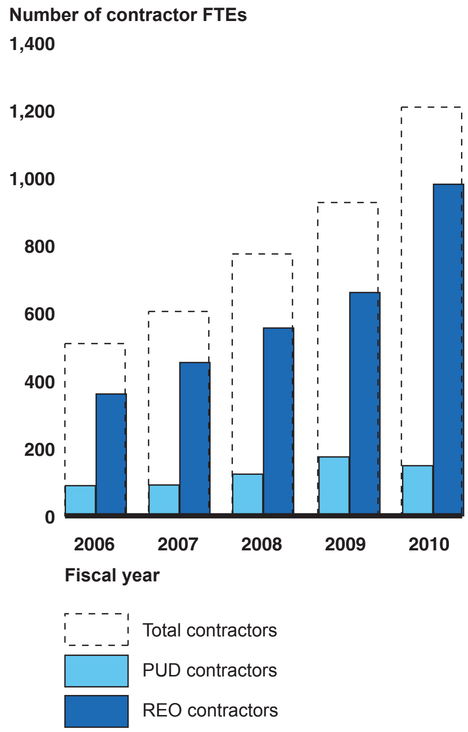
Although FHA Has Addressed Some Staffing Issues, It Lacks Strategic Workforce and Succession Planning

FHA has taken steps to address staffing challenges associated with the increase in its business volume and workload, but lacks strategic workforce and succession plans.

FHA Took Some Steps to Manage the Increased Business Volume

To handle the increased business volume, the homeownership centers hired more contractors, increased overtime, shared resources, and changed work processes. For example, to respond to dramatic increases in the number of FHA-insured loans and the inventory of foreclosed properties to be managed, the homeownership centers expanded their use of contractors hired to perform key functions in PUD and REO (see fig. 9). These contracts provided the homeownership centers with flexibility and the capability to respond to spikes in volume.

Figure 9: Selected FHA Single-Family Contractors, 2006–2010

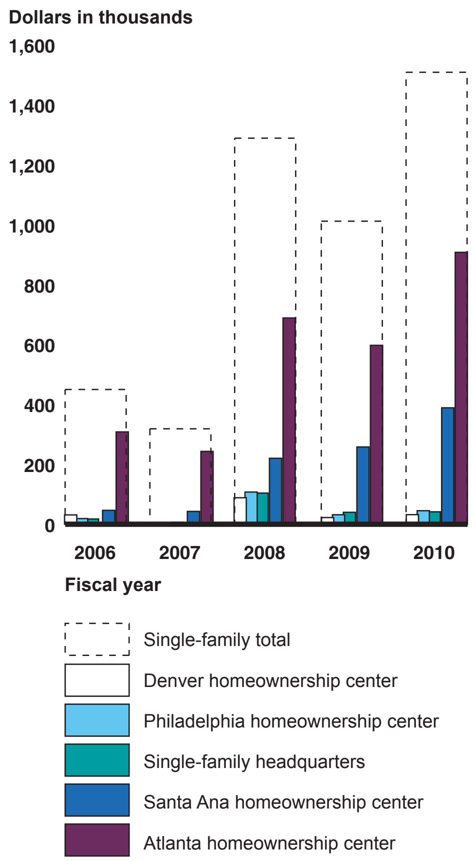


Source: GAO analysis of FHA data.

Note: The contractor FTE data provided by FHA were a head count of contractor employees for 2010 and estimates for 2006–2009 (based on the 2010 data).

In addition to relying on contractors to address the increased workload caused by FHA's large increase in business volume, the homeownership centers also used more overtime, although the use of overtime varied by center. As figure 10 shows, the Atlanta and Santa Ana homeownership centers used the vast majority of overtime, while the Denver and Philadelphia homeownership centers relied on overtime to a much lesser extent. During our visit to the Philadelphia center, FHA officials told us that they discouraged the use of overtime. Atlanta officials told us that they needed to use overtime to keep up with the increased workload.

Figure 10: FHA Single-Family Overtime Expenditures, 2006–2010



Source: GAO analysis of FHA data.

Additionally, the homeownership centers shared resources to handle the increased workload. At some centers, staff from one division helped other divisions. For example, at the Denver homeownership center, PSD staff assisted REO with payments related to foreclosed properties. Some homeownership centers with available staff picked up overflow work from other centers. For example, Santa Ana took responsibility for two REO contracts from Denver; however, once Santa Ana's workload increased, it could no longer support these contracts. Finally, the Philadelphia homeownership center took the lead on condominium recertification processing for all of the homeownership centers, allowing staff in these centers to focus on other workload items.[38]

Finally, as previously noted, FHA revised some of its business processes. For example, it revised its method for targeting loans for PETRs, which reduced the percentage of loans reviewed. It also reduced the number of appraisals that were reviewed for each appraiser targeted for review from 10 to 3.

FHA Lacks Strategic Workforce and Succession Plans

Although FHA has addressed staffing and training needs and succession planning to some extent, it lacks plans that strategically address future workforce needs, including the need to replace retiring staff. HUD guidance requires workforce planning that identifies the workforce needed to meet future challenges.[39] Moreover, our internal control standards require that management take steps to ensure that skill needs are continually assessed and that the organization is able to obtain a workforce that has the required skills that match those necessary to achieve organizational goals.[40] We have also reported that workforce planning practices used by leading organizations include a process to (1) define the critical skills and competencies that will be needed to achieve current and future programmatic results (including critical skill gaps) and (2) develop strategies tailored to address gaps in the number, skills, and competencies of staff.[41] In addition, internal control standards require that agencies, as part of their human capital planning, consider how best to retain valuable employees, plan for their eventual succession, and ensure continuity of needed skills and abilities. We have also reported that leading public organizations have adopted practices such as linking succession planning to strategic planning; emphasizing developmental assignments in addition to formal training; and addressing specific human

[38]The Housing and Economic Recovery Act of 2008 required FHA to implement a new approval process for condominium projects and insurance requirements for mortgages on individual units.

[39]Department of Housing and Urban Development, *Strategic Human Capital Management: Revised Human Capital Plan, FY 2008–FY 2009* (Washington, D.C.: March 2008). HUD has been revising this plan.

[40]GAO/AIMD-00-21.3.1.

[41]GAO, *Human Capital: Key Principles for Effective Strategic Workforce Planning*, GAO-04-39 (Washington, D.C.: Dec. 11, 2003).

capital challenges, such as diversity, leadership capacity, and retention.[42] Further, HUD guidance calls for a succession plan that includes, among other things, projections for retirements in mission-critical positions.

Although workforce planning practices used by leading organizations include defining critical skills and skill gaps, FHA's current approach to workforce planning does not have mechanisms for doing so. For the 4-year period from 2004 to 2008, FHA had a workforce plan that identified the critical competencies needed by employees over that period; analyzed skills and competencies, including gaps; and proposed comprehensive strategies to address these gaps.[43] Specifically, the plan described the most critical competencies for staff and included calculations of the gap for each competency (that is, the shortfall or deficit that results when the supply of staff proficient in a competency is less than the demand for that competency).

However, FHA has not created a multiyear workforce plan since then. Instead, it has relied on occasional REAP studies and annual managerial assessments of staffing and training needs. The most recent REAP study, completed in 2009, did not identify critical skills needed or strategies to address skill gaps. Rather, its purpose was to determine the proper staffing level for the four homeownership centers and the National Servicing Center.[44] In addition, FHA asks each program office to annually identify mission-critical positions that need to be filled. As part of identifying these positions, managers are to take into account upcoming initiatives that may require new or increase existing positions, and current goals, workload, vacancies, and expected attrition. FHA officials told us that they also used the results of the most recent REAP study in determining staffing needs. The result of the process is a spreadsheet listing positions they would like to fill that year. In addition, FHA's program offices produce similar

[42]GAO, *Human Capital: Insights for U.S. Agencies from Other Countries' Succession Planning and Management Initiatives*, GAO-03-914 (Washington, D.C.: Sept. 15, 2003).

[43]Department of Housing and Urban Development, *Strategic Workforce Plan, FY04 to FY08, Office of Housing,* (Washington, D.C.: July 2004).

[44]The 2009 REAP study found that these centers were understaffed by about 175 FTEs. However, agency officials told us that the Office of Single Family Housing has not been able to reach the staffing levels recommended in the REAP study because of budgetary constraints. As of May 2011, the homeownership centers and the National Servicing Center had 811 staff, as opposed to the 1,000 staff recommended in the REAP study and the 823 staff they had when the REAP was conducted in 2009.

spreadsheets annually for training needs. The training needs identified are based on managers' assessments of staff skill gaps, performance, and employee interest. The spreadsheet links requests for training from the program offices and the homeownership centers to a list of general and technical competencies that FHA officials told us were pulled from the Office of Personnel Management website in 2005.

FHA also does not currently have a succession plan as it has had in the past. In 2006, HUD developed a succession plan for 2006–2009 that covered various offices, including FHA. The plan

- identified all of the positions the program office deemed critical to meeting the goals and the objectives of its programs,
- analyzed whether existing staff in the positions had the required competencies to perform the jobs,
- assessed the number of retirement-eligible employees in critical and noncritical positions, and
- determined the probability of retirements over the next 3 years.[45]

Succession planning is particularly important because the Office of Single Family Housing could face numerous retirements. Almost 50 percent of Single Family Housing headquarters staff are eligible to retire within the next 3 years (see table 7). The percentage of staff eligible to retire at the homeownership centers is even higher. For example, 63 percent of homeownership center staff are eligible to retire within the next 3 years. For the three divisions (PUD, QAD, and REO) in the homeownership centers that conduct key workload items, 51, 65, and 60 percent, respectively, can retire in the next 3 years. During our visits to three of the four homeownership centers, officials consistently told us of the risk they faced with losing experienced staff to retirement. At one homeownership center, the PUD director told us that 80 percent of his staff were 45 or older.

[45] Department of Housing and Urban Development, *Succession Management Plan, Fiscal Year 2006-2009,* (Washington, D.C.: September 2006).

Table 7: Percentage of FHA Staff Eligible to Retire within the Next 1, 2, and 3 Years, as of July 2011

Entity	Eligible to retire within 1 year	Eligible to retire within 2 years	Eligible to retire within 3 years
Single-family headquarters staff	39	45	47
Homeownership centers	54	58	63
PUD	40	43	51
QAD	57	62	65
REO	47	53	60

Source: GAO analysis of FHA data.

While FHA has taken some steps to address succession planning, they have been limited. In recognition of the high percentage of staff eligible to retire, FHA implemented two initiatives focused on succession planning. The first initiative, known as the “three-deep” structure, was put in place in 2010. It is intended to help ensure that, at any given time, at least two additional supervisors, managers, or executives can perform the work of each supervisor, manager, or executive. However, this three-deep structure does not apply to other staff positions beyond management. The second initiative, the Foundation Leadership Program, also began in 2010. Its goal is to train and develop staff through a number of programs. They include the Student Intern Program, which exposes interns to the programmatic activities of the Office of Housing, and the Upward Mobility Program, which provides participants with a curriculum intended to expand their knowledge of the housing industry and enhance professional, analytical, and reasoning skills. Also included are the Management Development Program, which focuses on creating future leaders by providing targeted staff with essential leadership and management skills, and the Executive Development Program, which trains new supervisors and offers refresher courses and follow-on facilitative training to enhance leadership development of current managers. Neither initiative assesses the number of retirement-eligible employees in critical positions as required by HUD guidance. According to FHA officials, as resources have dwindled they have considered all of their positions to be critical.

According to FHA officials, plans to update their workforce and succession plans were suspended. In 2007–2009, FHA had a workforce planning process that was designed to identify critical skill gaps and a strategy for addressing these gaps. They stated that a contractor was hired to develop a database to store data collected on competencies and skill gaps. The intent was to use this information to identify training needs and conduct workforce and succession planning. According to the officials, HUD told FHA to stop this initiative in 2009 because HUD was going to implement the Learning Management System, which would be a workforce planning process for the entire department. However, this system never came to fruition because of funding shortages. The FHA officials told us that they were not aware of any efforts to reinstate the workforce planning process in place from 2007 to 2009. Without a more comprehensive workforce planning process that includes succession planning, FHA's ability to systematically identify the workforce needed for the future and plan for upcoming retirements is limited.

Conclusions

Through its single-family mortgage insurance programs, FHA has helped millions of families purchase homes. But the recent increased reliance on FHA mortgage insurance highlights the need for FHA to better ensure that it has the proper controls in place to minimize financial risks while meeting the housing needs of borrowers. Additionally, although FHA's single-family insurance programs historically have produced budgetary receipts for the federal government, a weakening in the performance of FHA-insured loans could increase the possibility that FHA will require additional funds to help cover its costs on insurance issued to date. Key factors in improving accountability and minimizing operational problems are implementing appropriate internal controls, regularly assessing them for effectiveness, and updating them as conditions change. Therefore, the need for a comprehensive risk assessment strategy, including quality control functions, has become more urgent as FHA's market role, business volume, and corresponding workload dramatically increased and staffing levels remained relatively constant. FHA has taken important steps toward developing a comprehensive risk assessment approach, including establishing an office of risk management, implementing a new system of management control in Single Family Housing, and identifying and addressing risks related to the rapid increase in business volume. However, key elements—such as the integration of separate risk assessment efforts, annual assessments of the risks from internal and external sources, and mechanisms to identify and address risks related to changing conditions—currently are missing from FHA's approach. For instance, one mechanism for identifying risks related to changing conditions could be to implement the template for reporting on major emerging risks that was recommended in the consultant's report commissioned by FHA. By incorporating these key elements, FHA could more effectively identify, plan for, and address risk.

Additionally, FHA's continued prominence in the mortgage market highlights the importance of helping to ensure that the agency has adequate staff to effectively oversee key program participants, such as lenders and appraisers. However, the high percentage of staff eligible to retire within the next 3 years presents workforce and succession planning challenges. Although workforce planning practices used by leading organizations include defining critical skills and skill gaps, FHA's current approach to workforce planning does not have mechanisms for doing so. And although the agency has taken some steps to address succession planning, it lacks a succession plan that covers managers and staff and highlights projected shortfalls in critical positions. Strategic workforce and succession planning efforts can provide a structure to address these issues. A more structured approach could enhance FHA's ability to identify critical skills and gaps, plan for upcoming retirements, and meet future demands of the program.

Recommendations for Executive Action

As FHA continues to implement its new risk assessment strategy, the Secretary of HUD should direct the Acting Assistant Secretary for Housing-Federal Housing Commissioner to take the following steps to comply with our internal control standards and HUD Handbook 1840.1:

- integrate the internal quality control initiative of the Office of Single Family Housing into the operational risk processes of the Office of Risk Management;
- conduct an annual risk assessment; and
- establish ongoing mechanisms—such as use of the report templates from the 2010 consultant's report—to anticipate and address risks that might be caused by changing conditions, including risks related to the rapid increase in single-family business volume.

Further, to help ensure that FHA has sufficient staff in place with the appropriate skills to oversee single-family insurance programs during a period of continued program demand, the Secretary of HUD should direct the Acting Assistant Secretary for Housing-Federal Housing Commissioner to develop

- a workforce plan for the Office of Single Family Housing that identifies the critical skills and competencies the agency will need to meet its future program goals, defines skill gaps, and includes a process to develop strategies to address gaps in the number, skills, and competencies of staff; and

- a succession plan that outlines steps to help ensure that qualified employees succeed members of the workforce expected to retire over the next several years.

Agency Comments and Our Evaluation

We provided a draft of this report to HUD. The Acting Assistant Secretary for Housing-Federal Housing Commissioner provided written comments, which are reprinted in appendix II. The agency agreed with our recommendations and stated that it either was working toward achieving the recommendations or had plans to do so in the very near future. For example, FHA said it would leverage or integrate existing risk management efforts as soon as ORM's final governance structure and risk management strategies were in place. The agency also stated that ORM would conduct an annual risk assessment as a component of its overall risk management strategy. It stressed that ongoing mechanisms to anticipate and address risks related to changing conditions would be part of ORM's strategy. Finally, it noted that it would develop a formal workforce plan and had efforts underway to develop a succession plan. FHA also provided technical comments, which we incorporated into the report where appropriate.

We will provide copies of this report to the Chairman and Ranking Member of the House Financial Services Committee and other interested congressional committees and to the Secretary of HUD. We also will make this report available at no charge on the GAO website at http://www.gao.gov. If you or your office have any questions about this report, please contact me at (202) 512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

Mathew Scirè
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

We examined the Federal Housing Administration's (FHA) oversight capacity in light of the recent expansion in its single-family mortgage insurance programs. Specifically, we (1) identified recent changes in FHA's volume, workload, and resources; (2) evaluated FHA's risk assessment strategy, including the extent to which it is consistent with Department of Housing and Urban Development (HUD) and GAO internal control standards; and (3) assessed the steps FHA has taken to manage the risks in its single-family mortgage insurance programs.

To determine changes in the volume of FHA's single-family business since 2006, we collected data on loan volume from FHA's quarterly reports to Congress on the Mutual Mortgage Insurance Fund and data on FHA's market share from HUD's quarterly reports on U.S. housing market conditions. To determine how FHA's workload has changed since 2006, we collected data for fiscal years 2006–2010 from the following systems:

- Computerized Homes Underwriting Management System—data on post-endorsement technical reviews, appraiser reviews, and appraiser sanctions;
- Approval Review and Recertification Tracking System—data on lender applications and lender reviews;
- Single Family Acquired Asset Management System—information on FHA's real estate-owned properties;
- HUD's Central Accounting and Program System—overtime expenditures; and
- Single Family Housing Data Enterprise Warehouse—data on loss mitigation actions.

We also reviewed FHA management reports to determine annual workload goals and compared actual work completed with stated goals. To determine resource changes since 2006, we analyzed data on staff assigned to the Office of Single Family Housing in fiscal years 2006–2010 and contractor staff hired to perform selected functions in the same period. The Office of Single Family Housing provided headquarters staffing levels from the National Finance Center payroll database. Each homeownership center provided its staffing levels in the form of monthly management reports. FHA provided estimates of contractor full-time equivalent levels based on current contractor levels and past workload. To assess the reliability of these data, we reviewed documentation from

FHA on internal controls, interviewed FHA officials who administer these systems and officials who routinely use the systems for workload management, and verified selected data across multiple sources (including annual FHA management reports). We determined that the data were sufficiently reliable for our purposes.

To evaluate the extent to which FHA's risk assessment strategy is consistent with our and HUD's risk assessment requirements and guidelines, we reviewed (1) the Federal Managers' Financial Integrity Act requirements, (2) our internal control standards and evaluation tool, (3) HUD's management control handbook, and (4) Office of Management and Budget Circular No. A-123 requirements relating to an internal control structure for risk assessment.[1] To identify FHA's risk assessment strategy, we reviewed HUD Inspector General audit reports, including a 2008 report on Single Family Housing's failure to fully implement an internal control structure in accordance with requirements.[2] And we reviewed the independent auditor's report (which accompanied the audit of FHA financial statements for 2008–2010) on the agency's internal control deficiencies.[3] Further, we reviewed (1) Single Family Housing's management plans for the quality control initiative and examples of risk assessment worksheets, quarterly status reports, and other documentation related to the quality control initiative, and (2) a consultant's report on options and recommendations for the proposed structure and functions of the Office of

[1]See GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999); GAO, *Internal Control Management and Evaluation Tool*, GAO-01-1008G (Washington, D.C.: August 2001); and Department of Housing and Urban Development, Office of the Chief Financial Officer, *Departmental Management Control Program*, Handbook 1840.1 Rev-3 (Washington, D.C.: 1999).

[2]Department of Housing and Urban Development, Office of the Inspector General, *HUD's Office of Single Family Housing Had Not Fully Implemented an Internal Control Structure in Accordance with Requirements*, Audit Report 2008-KC-0006 (Washington, D.C.: Sept. 8, 2008).

[3]See Department of Housing and Urban Development, Office of the Inspector General, *Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2010 and 2009*, Audit Report 2011-FO-0002 (Washington, D.C.: Nov. 5, 2010); Department of Housing and Urban Development, Office of the Inspector General, *Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2009 and 2008*, Audit Report 2010-FO-0002 (Washington, D.C.: Nov. 13, 2009); and Department of Housing and Urban Development, Office of the Inspector General, *Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2008 and 2007*, Audit Report 2009-FO-0002 (Washington, D.C.: Nov. 7, 2008).

Risk Management in the Office of Risk Management and Regulatory Affairs.[4] We interviewed single-family staff in headquarters, the quality control coordinators and other staff at the homeownership centers, and Office of Risk Management and Regulatory Affairs staff. We then compared FHA's existing and proposed risk assessment strategy with our internal control standards and the HUD handbook.

To describe the steps FHA took to manage the risks it identified in the single-family insurance programs, we focused on efforts related to credit and counterparty risk, information technology, and human capital.

Credit and Counterparty Risk

To determine the steps FHA took to address credit risk, we summarized enhancements the agency made or intends to make (as described in our prior report on the financial condition of the Mutual Mortgage Insurance Fund).[5] We reviewed FHA program changes to account for any updates since we issued that report. We also reviewed information from the Office of Risk Management and Regulatory Affairs on more recent changes FHA made to address credit risk, such as those associated with FHA's Technology Open to Approved Lenders scorecard, which is used to assess a borrower's risk of default quickly and efficiently by examining the data the borrower provides on the loan application and the borrower's credit score.

To identify the steps FHA took to address counterparty risk—that is, risks posed by lenders and appraisers—we reviewed changes to FHA's final rule related to prohibiting loan correspondents from directly participating in the single-family insurance programs and increasing the net worth requirement for FHA-approved lenders.[6] The final rule included information on FHA's rationale for the changes and concerns program stakeholders raised. We also reviewed HUD mortgagee letters (written instructions to FHA-approved lenders) related to the rule changes. To determine how FHA changed its oversight of lenders and appraisers, we reviewed FHA's revised guidance on the post-endorsement technical

[4]McKinsey & Company, *Building the ORM Organization, Close-out Materials*, a report prepared at the request of the Department of Housing and Urban Development, December 2010.

[5]GAO, *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition*, GAO-10-827R (Washington, D.C.: Sept. 14, 2010).

[6]75 Fed. Reg. 20718 (Apr. 20, 2010).

review process and documentation on changes to the risk-based criteria used to identify lenders and appraisers for review. We also interviewed FHA officials at headquarters and the four homeownership centers for more information. To describe the advantages and disadvantages of the changes FHA made, we interviewed FHA officials at headquarters and the homeownership centers and officials at the Mortgage Bankers Association and the Independent Community Bankers of America.

Information Technology Risk

To determine the steps FHA took to manage the risks associated with its information systems, we reviewed documentation on challenges that FHA and the independent auditor identified in relation to major systems supporting the single-family programs. These include FHA's 2009 Information Technology Strategy and Improvement Plan and Infrastructure Transformation Initiative Concept of Operations, and reports from the independent auditor for 2008–2010.[7] To obtain information on the challenges rapid growth in business volume posed for FHA's information systems, we reviewed a consultant's 2009 Risk Capacity Study on the single-family program and the 2009 Resource Estimation and Allocation Process (REAP) study.[8] We interviewed Single Family Housing headquarters staff and staff at the four homeownership centers about how the information systems performed during the initial period of rapid growth and subsequently. To determine the steps FHA took to modernize its information systems, we reviewed numerous documents related to its Infrastructure Transformation Initiative, including the Concept of Operations and the Project Management Plan and our

[7]Department of Housing and Urban Development, *FHA Office of Housing Information Technology Strategy and Improvement Plan* (Washington, D.C.: Aug. 13, 2009), and Department of Housing and Urban Development, *Infrastructure Transformation Initiative: Infrastructure for Transformed Operations Concept of Operations Version 2.0* (Washington, D.C.: September 2010).

[8]G&B Solutions and KPMG, *Risk Capacity Study, Single Family Housing Application and Endorsement Processes*, a report prepared at the request of the Department of Housing and Urban Development, Feb. 2, 2009, and Department of Housing and Urban Development, *Resource Estimation and Allocation Process (REAP), Office of Housing, DAS for Single Family Housing, Study #1: Office of Single Family Housing–Field* (Washington, D.C.: September 2009).

prior work on HUD's information systems.[9] We met with FHA and HUD officials responsible for various aspects of the initiative to learn more about it, the deliverables for the first 18 months of the project, and any issues faced. To determine the steps FHA took to address risks and fraud related to use of information systems, we reviewed the request for proposals for the Risk and Fraud Initiative and task orders for some associated projects. To determine the status of FHA efforts for the initiative, we reviewed documents describing deliverables for the first 18 months of the project and interviewed FHA officials, including the FHA Transformation Initiative program manager.[10]

Human Capital Risk

To assess the steps FHA took to address its staffing needs, we reviewed FHA guidance on factors managers should take into account when assessing annual staffing needs. We also reviewed the 2009 REAP study to find out recommended staffing levels for the Office of Single Family Housing. To determine the number of staff in the Office of Single Family Housing eligible to retire in the next 3 years, we analyzed National Finance Center data provided by FHA. To determine what initiatives FHA had in place to address succession planning, we reviewed documents from FHA that described its "three-deep" initiative and Foundation Leadership Program. We also interviewed officials from FHA's Office of Operations to learn more about workforce and succession planning. As part of these interviews, we obtained information on the workforce planning initiative FHA had in place during 2007–2009. To determine the extent to which FHA's current workforce and succession planning efforts were consistent with GAO and HUD human capital criteria, we reviewed our internal control standards related to workforce and succession planning, a GAO report on key principles for strategic workforce planning,

[9]Department of Housing and Urban Development, *Project Management Plan: Transformation Initiative* (Washington, D.C.: Aug. 17, 2011); GAO, *Information Technology: HUD Needs to Better Define Commitments and Disclose Risks for Modernization Projects in Future Expenditure Plans*, GAO-11-72 (Washington, D.C.: Nov. 23, 2011); and GAO, *Information Technology: HUD's Expenditure Plan Satisfies Statutory Conditions, and Implementation of Management Controls Is Under Way*, GAO-11-762 (Washington, D.C.: Sept. 7, 2011).

[10]Department of Housing and Urban Development, *Appendix C: FHA Transformation* (Washington, D.C.: February 2011).

and HUD's Strategic Human Capital Plan.[11] We also reviewed prior HUD workforce and succession planning reports.[12]

We conducted this performance audit from October 2010 to November 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[11]GAO/AIMD-00-21.3.1; GAO, *Human Capital: Key Principles for Effective Strategic Workforce Planning*, GAO-04-39 (Washington, D.C.: Dec. 11, 2003); and Department of Housing and Urban Development, *Strategic Human Capital Management: Revised Human Capital Plan, FY 2008–FY 2009* (Washington, D.C.: March 2008).

[12]Department of Housing and Urban Development, *Strategic Workforce Plan: FY04 to FY08* (Washington, D.C.: July 2004), and Department of Housing and Urban Development, *Succession Management Plan: Fiscal Year 2006–2009* (Washington, D.C.: September 2006).

Appendix II: 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 26 2011

Mr. Mathew J. Scirè
Director
Financial Markets and Community Investment
Government Accountability Office
441 G Street, NW
Washington, DC 20548-0001

Dear Mr. Scirè:

Thank you for the opportunity to comment on the GAO Final Report entitled, "Federal Housing Administration: Improvement Needed in Risk Assessment and Human Capital Management." This letter conveys HUD's response to the audit.

As detailed in the report, FHA has taken a number of proactive steps to improve its management of risk, and to leverage its limited resources to meet increased workload demands. FHA has implemented several significant policy and operational changes to its lender approval, monitoring and enforcement activities. And ongoing efforts to modernize HUD's information technology systems will further enhance FHA's ability to execute a robust counterparty risk management strategy. We are confident that the changes we have made, and the continued improvements that are still forthcoming, will better equip FHA to carry out its important role in a 21st century housing finance system. We are pleased that GAO has recognized our efforts in its report.

In addition, both Bob Ryan, as the previous Deputy Assistant Secretary for Risk, and I have remained focused on risk management activities and staffing throughout this period. HUD has also made significant progress in filling leadership positions, and we will have our full senior management team in place very soon. We are confident that they will provide the ongoing leadership necessary to continue our efforts to ensure that FHA possesses the policies, processes, and systems necessary to effectively manage its risk at this important period in its history.

With regard to the recommendations found in the report, FHA's specific responses to each are below. But at the outset, it should be noted that FHA agrees with the GAO's recommendations and is either currently working toward the achievement of those recommendations, or has plans to do so in the very near future. Indeed, even before this audit, in addition to its efforts to strengthen existing offices and processes, FHA has been working diligently to establish the new Office of Risk Management and Regulatory Affairs, and to integrate its activities with those of FHA's program offices. And efforts to update and utilize FHA's workforce and succession plans are currently underway.

Recommendation:
Integrate the internal quality control initiative of the Office of Single Family Housing into the operational risk processes of the Office of Risk Management.

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HUD Response:
As the risk management strategies and processes of the Office of Risk Management and Regulatory Affairs (ORM) continue to be developed, ORM will endeavor to leverage and/or integrate with existing risk management efforts. ORM's strategy is intended to be complementary to the activities of FHA's program offices, and where existing program office initiatives are sufficient for the purposes for which they are intended, they will be retained; where they are not, ORM will ensure that new mechanisms are employed.

Such integration will take place as soon as ORM's final governance structure and risk management strategies are in place.

Recommendation:
Conduct an annual risk assessment.

HUD Response:
As a component of its overall risk management strategy, ORM will conduct an annual risk assessment.

Recommendation:
Establish ongoing mechanisms – such as use of the report templates from the 2010 consultant's report – to anticipate and address risks that might be caused by changing conditions, including risks related to the rapid increase in single-family business volume.

HUD Response:
As a part of the ORM governance policy, ORM will consider how risk assessments will be conducted, as well as appropriate report formats such as those recommended in the consultant's study. However, regardless of the specific formats and operational details, ongoing mechanisms to anticipate and address risks related to changing conditions will most certainly be a component of ORM's risk management strategy.

Recommendation:
Develop a workforce plan for the Office of Single Family Housing that identifies the critical skills and competencies the agency will need to meet its future program goals, defines skill gaps, and includes a process to develop strategies to address gaps in the number, skills and competencies of staff.

HUD Response:
A formal workforce plan as outlined in the recommendation will be developed. However, it should also be noted that FHA does presently engage in workforce planning activities, although without utilizing a plan as described in the GAO's recommendation. When developing yearly hiring plans, FHA looks at key indicators, including but not limited to, retirement eligibility, critical vacancies, and the previous year's training needs assessments to determine which positions it will recruit for and which can be filled through additional training of existing staff. Additionally, FHA faces significant resource limitations which have impacts on formal workforce planning.

While FHA can endeavor to identify and compensate for skill gaps and competency needs, the ability to execute its plans is dependent upon requisite appropriations from Congress. As noted in the report, while FHA's workload has increased substantially over the past few years, its staffing levels have remained relatively constant. Although the realities of the appropriations process do not obviate the need for workforce planning, they do significantly constrain the effective utilization of the plans that are developed.

Recommendation:
Develop a succession plan that outlines steps to help ensure that qualified employees succeed members of the workforce expected to retire over the next several years.

HUD Response:
A succession plan will be developed, and efforts to achieve this are already underway. Building upon the work completed in 2007-2009 to develop a Departmental succession plan, FHA is currently updating its succession plan to identify and prioritize hiring to fill critical skill gaps, provide training to ensure staff possess key competencies, and prepare for expected retirements. This work will continue, resulting in the succession plan envisioned by GAO.

Conclusion

We appreciate the efforts of the GAO to review our progress and suggest future recommendations to strengthen our risk management and human capital management processes. Ensuring FHA's soundness in these areas is of vital importance to our ability to efficiently and effectively meet the needs of American taxpayers – both when workload volumes are at normal levels, and even more so when they are at elevated levels such as we are now experiencing. That is why we have undertaken the large number of efforts to improve our policies, procedures, staffing and systems referred to in the report. We will continue to implement our initiatives so that FHA can continue to deliver the services our economy requires.

Sincerely,

Carol J. Galante

Carol J. Galante
Acting Assistant Secretary for Housing-
Federal Housing Commissioner

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Mathew J. Scirè, (202) 512-8678 or sciremj@gao.gov

Staff Acknowledgments

In addition to the contact named above, Paige Smith (Assistant Director), Dan Alspaugh, Rudy Chatlos, John McGrail, Marc Molino, Teresa Neven, José R. Peña, Beth Reed Fritts, and Barbara Roesmann made key contributions to this report.

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