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Insured Multifamily and Healthcare Programs Washington, DC

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TO: Carol Galante, FHA Commissioner-Assistant Secretary, Office of Housing, H

FROM: Nikita N. Irons, Regional Inspector General for Audit, Atlanta Region, 4AGA

SUBJECT: The Office of Housing Had Not Fully Developed Formal Risk Based Procedures for Postendorsement Underwriting Reviews of Multifamily and Healthcare Loans

Attached are the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final results of our review of the Office of Housing's multifamily and healthcare insured mortgage programs.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 404-331-3369.

Date of Issuance: May 13, 2013

The Office of Housing Had Not Fully Developed Formal Risk-Based Procedures for Postendorsement Underwriting Reviews of Multifamily and Healthcare Loans

Highlights

Audit Report 2013-AT-0001

What We Audited and Why

We audited certain portions of the U.S. Department of Housing and Urban Development's (HUD) multifamily housing and healthcare insured mortgage programs as part of our fiscal year 2012 annual audit plan. The objective of the review was to determine the adequacy of the Office of Housing's procedures and controls for selecting, conducting, and following up on postendorsement underwriting reviews of insured multifamily and healthcare loans and use of the reviews to identify and correct adverse underwriting conditions detected by them. We did not review any other aspects of their risk-based programs beyond postendorsement underwriting reviews.

What We Recommend

We recommend that the Assistant Secretary for Housing-FHA [Federal Housing Administration] Commissioner develop and implement more complete written procedures and controls for conducting and following up on postendorsement underwriting reviews of HUD's insured multifamily and healthcare loans processed by the Office of Multifamily Housing Programs and the Office of Healthcare Programs.

What We Found

For the audit period ending December 2011, the Office of Housing had not fully developed formal risk-based procedures and controls for postendorsement underwriting reviews of insured loans for multifamily and healthcare (Section 232) projects. These conditions occurred because senior management had not fully implemented departmental guidance for management controls. The audit identified the need for improvement in several areas, including but not limited to instances in which required postendorsement underwriting reviews were not conducted, no postendorsement review requirements for some project types, and more complete procedures for follow-up on review results. The failure to conduct the reviews in all cases where they were required or needed represented missed opportunities to identify adverse underwriting patterns and correct them in a timely manner in an effort to help reduce losses to the insurance fund.

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BACKGROUND AND OBJECTIVE

Since 1937, the U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) multifamily mortgage insurance has been a major source of financing for affordable housing. Between January 1, 2007, and December 31, 2011, FHA insured more than $47.4 billion in mortgage loans to facilitate the construction, substantial rehabilitation, purchase, and refinancing of multifamily housing projects and healthcare facilities. FHA mortgage insurance protects lenders against financial losses stemming from defaults. HUD's Office of Housing is responsible for establishing requirements for the administration of HUD's multifamily mortgage insurance program primarily through its Office of Multifamily Housing Programs and the Office of Healthcare Programs.

Starting in 2009, Housing initiated and later completed major changes to enhance its underwriting processes for multifamily and healthcare insured loans. The changes included but were not limited to revisions to its underwriting procedures, implementation of Multifamily hub and national loan review committees, the establishment of the Office of Healthcare Programs in April 2009, and the transfer of the Section 232 program from multifamily to healthcare. The changes were designed and implemented to improve the quality of underwriting for multifamily and healthcare loans. Specifically

- Multifamily is responsible for the overall management, development, direction, and administration of HUD's multifamily housing programs. It provides direction and oversight for FHA mortgage insurance loan origination using multifamily accelerated processing (MAP) and traditional application processing (TAP). HUD designed MAP to establish national standards for approved lenders to follow when preparing, processing, and submitting loan applications for FHA multifamily mortgage insurance. The MAP program is intended to provide a consistent, expedited mortgage insurance application process at each HUD Multifamily hub or program center. The Multifamily Lender Qualification and Monitoring Division (LQMD) is responsible for monitoring MAP lenders and providing general oversight of lender performance. Housing had not established formalized requirements to monitor TAP loans underwritten and approved by HUD staff.

- Healthcare is responsible for the administration, processing, and approval of loans for healthcare projects. The office administers FHA's healthcare programs that provide mortgage insurance on loans that finance the construction, renovation, acquisition, or refinancing of healthcare facilities, such as residential care facilities and hospitals. The office processes Section 232 loans using LEAN[1] processing, developed in 2008 for Section 232 applications. All Section 232 loans are processed and approved by healthcare's headquarters office staff.

[1] LEAN refers to the procedures implemented by HUD which standardized the process used by lenders to assemble Section 232 loan application packages and for use by HUD staff to underwrite the applications.

The objective of the audit was to review the adequacy of procedures and controls used by the Office of Housing for selecting, conducting, and following up on postendorsement underwriting reviews of multifamily and healthcare insured loans and use of the reviews to identify and correct adverse underwriting conditions detected by them.

RESULTS OF AUDIT

Finding: The Office of Housing Had Not Fully Developed Formal Risk-Based Controls and Procedures for Postendorsement Underwriting Reviews of Multifamily and Healthcare Loans

The Office of Housing could improve the postendorsement review process by more fully developing formal risk-based procedures and controls for conducting, following up on, and assessing the results of postendorsement underwriting reviews of insured loans for multifamily and healthcare (Section 232) projects and better adherence to procedures that were in place. We identified the need to develop and formalize more complete written procedures for conducting (1) postendorsement underwriting reviews by Multifamily, (2) trend assessments by Multifamily, and (3) postendorsement underwriting reviews and trend assessments by Healthcare. These conditions occurred because senior management within Housing had not fully implemented required management controls. The failure to conduct the reviews in all cases where they were required or needed represented missed opportunities to identify adverse underwriting patterns and correct them in a timely manner in an effort to help reduce losses to the insurance fund.

More Complete Procedures and Controls Needed for Conducting Postendorsement Underwriting Reviews

Housing had not fully developed formal risk-based monitoring procedures and controls to ensure that Multifamily and Healthcare conducted and properly followed up on postendorsement underwriting reviews. HUD Handbook 1840.1, Departmental Management Control Program, paragraph 1-3(D)(4), provides that the Assistant Secretary for Housing is responsible for implementing management control requirements for the Office of Housing. Office of Management and Budget Circular A-123, Section IV, requires managers to continuously monitor and assess the effectiveness of management controls for their programs.

Multifamily and Healthcare did not conduct all postendorsement reviews that were required, did not require reviews for some project types, or did not conduct the required number of reviews. The additional information obtained from the reviews could have helped Housing identify inadequate underwriting patterns and the ability to initiate timely action to correct them. This condition occurred because senior managers in Housing had not fully established formalized the required complete risk-based procedures and controls.

Better Compliance Needed for Postendorsement Underwriting Reviews and Better Procedures for Trend Assessments by Multifamily

Housing had not fully established formal adequate risk-based controls and procedures for postendorsement underwriting reviews of loans processed and approved by Multifamily using traditional application processing (TAP), and multifamily application processing (MAP). Handbook 1840.1, Paragraph 7-3, requires that all monitoring is to be based on the application of risk management concepts. As a result, Housing did not have readily available trend information needed from the reviews to assess and correct any adverse underwriting patterns that the reviews may have identified to help protect the insurance fund from losses.

Traditional Application Processing - Housing had not fully established formal risk-based procedures and controls to select, conduct, follow up, and access postendorsement underwriting reviews of TAP loans that were underwritten and approved by HUD staff. This condition was significant considering that during our audit period, January 2007 through December 2011, HUD's system showed that Multifamily had 19 early assigned TAP loans, but Multifamily reviewed only 1[2] of the loans in 2010, leaving 18 loans with mortgages totaling more than $140 million that were not reviewed. Multifamily had established requirements to review all early assigned and a sample of other MAP loans, but it had not established similar requirements for TAP loans.

Section 1-4 of The Multifamily Lender Qualification and Monitoring Division's (LQMD) internal desk guide provides that LQMD may conduct reviews of TAP loans underwritten by HUD staff. However, this statement was not a requirement to conduct the reviews. Multifamily officials stated that they did not believe that it was necessary or a good use of resources to establish procedures to conduct postendorsement reviews of TAP loans because TAP loans represented only about 2 or 3 percent of their production volume. Multifamily officials further stated that about a third of the TAP loans identified in HUD's system were erroneously coded and should have been recorded as MAP loans. Multifamily officials stated that this data integrity issue was caused by misclassifications when the staff entered the information into HUD's system. As a result of this condition, we could not readily identify how many TAP loans were in Multifamily's inventory. However, as long as TAP loans are a part of Multifamily processing then they are subject to HUD's risk-based monitoring requirements.

[2] We identified this review, although a Multifamily official stated that Multifamily did not perform postendorsement underwriting reviews of TAP loans.

Multifamily officials stated that although TAP loans were not reviewed by LQMD, they were included in the pool of pipeline loans (loans still in the underwriting process) reviewed by the Office of Risk Management. They stated that Risk Management randomly selected five loans per month for postcommitment quality control reviews through a memorandum of understanding with Multifamily, which was executed in February 2012.[3] The memorandum provided that the reviews were to evaluate the quality of multifamily underwriting to ensure that underwriters complied with the MAP guide but the MAP guide is not applicable to TAP loans. In addition, the memorandum did not specifically provide for the selection and review of TAP loans.

Multifamily Accelerated Processing - Housing had not fully established formal risk-based postendorsement underwriting review procedures for Multifamily, and it needed to improve written procedures and controls to ensure that Multifamily followed requirements that were in place for conducting postendorsement underwriting reviews of early assigned MAP loans. Section 4-4 of LQMD's internal desk guide requires postendorsement underwriting reviews of all early assigned loans (assigned within 4 years of endorsement) and selective review of other MAP loans based on various loan and project characteristics, including but not limited to mortgage amount, default or election to assign within 4 years of final endorsement, size of the project, and geographic location. Specifically, Multifamily had not

- Conducted postendorsement underwriting reviews of all early assigned MAP loans since 2009. Multifamily conducted reviews of only 12 of the 34 MAP loans that were early assigned during the period covered by the review, January 1, 2007, through December 31, 2011. This left 22 loans with mortgages totaling more than $268 million that were not reviewed, although Multifamily was required to review all early assigned loans (Section 4-4 of LQMD internal desk guide). The Director of LQMD stated that no other reviews were conducted in 2010 and 2011 because LQMD was in the process of reevaluating and revising its monitoring processes and procedures. The Director stated that in 2012 LQMD had resumed performing postendorsement underwriting reviews of early assigned loans as part of its lender reviews and that reviews of several of the other early assigned loans questioned as not reviewed were underway or would be scheduled.

- Fully established and implemented formal risk-based procedures for determining the number of reviews to conduct, selecting risk-based samples, and following up on MAP loans that were not early assignments. Handbook 1840.1, Paragraph 7-3 requires (a) identification of the monitoring objective to determine what is to be monitored, (b), timely risk-based monitoring, (c) selection of programs/program participants for monitoring, and (d)

[3] This was after we started our audit.

documenting the process and recording the rationale for choosing participants. Although procedures were lacking, LQMD reviewed 44 loans that were not early assignments and 1 early assigned TAP loan. We observed that Housing's Office of Evaluation produced and distributed comprehensive and thorough trend reports that could be used to assist in the risk-based assessments required for selecting loans for postendorsement review. For instance, the reports showed beneficial information such as endorsements, claims, defaults, and delinquencies by HUD office and section of the Housing Act.

- Fully established and implemented timeframes for conducting postendorsement underwriting reviews of early assigned and other loans. When we brought this matter to the attention of Multifamily officials, they revised LQMD's internal desk guide to specify that all early claim MAP loans would be reviewed within 1 year of claim, but they did not specify a timeframe for conducting reviews of loans that were not early claim. The guide provided only that LQMD would review a sample of other loans to the extent that it had the capacity to do so with no reference to a timeframe and the number of loans to be reviewed.

- Fully developed procedures to assess and document trends identified by the postendorsement underwriting reviews and follow up to address corrective action when needed. Handbook 1840.1, Paragraph 7-3, requires identifying whether follow-up corrective actions are necessary. Multifamily officials acknowledged the lack of written procedures related to these two issues. They stated that the collection and analysis of LQMD's underwriting review results were documented in HUD's SharePoint and the results were discussed in the minutes of monthly staff meetings and that they provide MAP training to address underwriting deficiencies and program violations. Multifamily officials believed that the assessing and tracking approaches they had in place were adequate and did not believe that written procedures were required. We believe that written procedures are needed to ensure that the data is compiled and assessed in a consistent manner and to help enhance the results for use by Housing to identify risk areas that should be considered when establishing monitoring objective as required by Handbook 1840.1, paragraph 7.5D.

  For instance, in 2009, LQMD prepared a comprehensive report with background information on defaults and claims by HUD field offices; lender default and claim activity; and a summary of risk factors, trends, and recommended actions associated with its planning, conducting, and assessment of 23 postendorsement reviews conducted in 2008. The report was an effective example of the type of periodic assessments of postendorsement underwriting review results that, as discussed above, is required to help in establishing risk based monitoring objectives. We assessed the results of 22 postendorsement reviews and the results confirmed the trends cited in HUD's assessment. We found no evidence of a similar assessment since 2009.

No Postendorsement Underwriting Reviews and Trend Assessments by Healthcare

Housing had not fully established formal risk-based postendorsement underwriting review procedures and controls for Section 232 loans processed and approved by Healthcare. Handbook 1840.1, Paragraph 7-3, requires that all monitoring is to be based on the application of risk management concepts. In addition, neither Housing nor Healthcare had conducted or arranged for others to conduct postendorsement underwriting reviews of Section 232 loans since Healthcare received responsibility for the program from Multifamily in March 2009. The reviews were needed to ensure that lenders and HUD staff complied with FHA underwriting requirements and help reduce the risk of losses to the insurance funds due to poor quality underwriting.

The absence of reviews was significant, considering that from January 2010 through December 2011, Healthcare endorsed more than 730 Section 232 loans with mortgages that totaled more than $6 billion.[4] Specifically, Housing had not established and implemented risk-based procedures and controls to be followed by Healthcare staff to

- Determine the number of postendorsement underwriting reviews to conduct;
- Select risk-based samples of loans for postendorsement review;
- Conduct and document the reviews;
- Follow up and resolve review findings; and
- Assess, develop, and follow up on trends resulting from reviews.

A Healthcare representative stated that Healthcare had not conducted or asked LQMD to conduct postendorsement underwriting reviews because it did not feel that the reviews were necessary, considering the extensive underwriting controls that Healthcare had put in place. This comment was not consistent with Handbook 1840.1, Paragraph 7-3, which requires (a) identification of the monitoring objective to determine what is to be monitored, (b), timely risk-based monitoring, (c) selection of programs/program participants for monitoring, (d) identification of whether follow-up corrective actions are necessary, and (e) documenting the process and recording the rationale for choosing participants. Further, trend data prepared by Housing's Office of Evaluation showed increasing delinquencies for Section 232 loans, which highlights the need to consider such projects for postendorsement underwriting reviews. Specifically, the March 2012

[4] We found no evidence that any of the endorsed loans had gone to early assignment.

report showed 20 delinquencies and claims in the fourth quarter of 2009 and 36 in March 2012, representing an 80 percent increase.[5]

We do not question Healthcare's claim of a thorough underwriting process but we do questions Housing's under-developed written procedures to subject Healthcare's underwriting process to the required risk based monitoring requirements in Handbook 1840,1, paragraph 7-3.

Conclusion

Housing needs to fully develop formal risk-based procedures and controls for Multifamily and Healthcare to conduct, follow up on, and assess the results of postendorsement underwriting reviews. These conditions occurred because senior management within Housing had not fully developed and implemented required management controls. The conditions are significant, considering that during the 5-year audit period, Housing endorsed 86 loans with mortgages totaling more than $1.3 billion that were either delinquent, in default, or assigned. The average mortgage for a troubled loan amounted to more than $16 million, coupled with a HUD recovery of only 48 percent of mortgage amounts on note sale loans.[6] Thus, a single troubled loan had the potential of exposing HUD's insurance fund to millions of dollars in losses. This condition underscores the importance of having fully developed procedures and controls for conducting postendorsement underwriting reviews. The failure to conduct the reviews in all cases where they were required or needed represented missed opportunities to identify adverse underwriting patterns and correct them in a timely manner in an effort to help reduce losses to the insurance fund.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner

1A. Develop and implement more complete and formalized written procedures and controls for risk-based postendorsement underwriting, complete with objectives and procedures for Multifamily and Healthcare for selecting samples, conducting and documenting reviews, resolving review findings, assessing the reviews for adverse underwriting trends, and following up on trends identified by the reviews.

[5] We recognize that some of the delinquencies and claims may relate to loans processed and approved by Multifamily before Healthcare took over the Section 232 program in 2009. However, the monitoring requirements previously cited for Handbook 1840.1 is applicable to Housing without regard to whether the loans were processed and approved by Multifamily or Healthcare. In this case, Healthcare is now responsible for the monitoring.

[6] We obtained the recovery percentage from Housing's Office of Asset Sales based on multifamily and healthcare loan note sales from September 2007 to December 2011.

SCOPE AND METHODOLOGY

We performed the review from January to October 2012 at HUD headquarters in Washington, DC, and Office of Inspector General (OIG) offices in Jacksonville, FL, and Atlanta, GA. The audit survey covered the period January 1, 2007, through December 31, 2011. We adjusted the period when necessary.

To accomplish our audit objective, we

- Reviewed reports issued by the Government Accountability Office (GAO) from 2002 to 2011 to identify issues and recommendations that were relevant to our survey objectives and determine whether HUD had initiated appropriate actions to address the concerns raised by GAO.

- Reviewed recent OIG reports related to our survey objective.

- Interviewed Multifamily and Healthcare headquarters officials and reviewed the policies and procedures they used to process and underwrite multifamily loans and conduct and follow up on postendorsement underwriting reviews.

- Reviewed reports issued by the Office of Evaluation on delinquency and claim rate activity and trends.

- Reviewed HUD's information system data on insured multifamily and healthcare loans for patterns and trends such as defaults, delinquencies, assignments, high default and claim lenders, and high default and claim hubs and field offices. We did not test the reliability of the system from which the data was obtained because we only used it for background and informational purposes.

- Selected and reviewed all 22 reports involving defaulted loans from among 57 LQMD postendorsement review reports issued between 2007 and 2011 for underwriting deficiency patterns and trends.

We conducted the audit 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 objective. We believe that the evidence obtained provides a reasonable basis for our finding and conclusion based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Compliance with laws and regulations to ensure that the Office of Housing developed and implemented comprehensive procedures and controls for postendorsement underwriting reviews of HUD have insured multifamily and healthcare loans.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The Office of Housing had not fully developed formal comprehensive risk-based controls and procedures for postendorsement underwriting reviews of multifamily and healthcare loans (finding 1).

APPENDIX

The Assistant Secretary for Housing-Federal Housing Commissioner informed us by email that she agreed with the draft report as revised to address concerns raised by her and her staff at the exit conference and that she had no written comments for use to include in the final report.