OFFICE OF AUDIT
REGION 9
LOS ANGELES, CA

Office of Single Family Housing
Washington, DC

FHA Preforeclosure Sales Program

2013-LA-0002 SEPTEMBER 5, 2013

Issue Date: September 5, 2013

Audit Report Number: 2013-LA-0002

TO: Charles S. Coulter
Deputy Assistant Secretary for Single Family Housing, HU

Monica A. Clarke
Deputy Assistant Secretary for Finance and Budget (Acting), HW

FROM: Tanya E. Schulze
Regional Inspector General for Audit, Los Angeles Region, 9DGA

SUBJECT: FHA Paid Claims for Approximately 4,457 Preforeclosure Sales That Did Not Meet Minimum Net Sales Proceeds Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's oversight of Federal Housing Administration (FHA) Preforeclosure Sales Program claims.

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 213-894-8016.

September 5, 2013

FHA Paid Claims for Approximately 4,457 Preforeclosure Sales That Did Not Meet Minimum Net Sales Proceeds Requirements

Highlights

Audit Report 2013-LA-0002

What We Audited and Why

We audited the Federal Housing Administration (FHA) Preforeclosure Sales Program claim process. We initiated the nationwide audit in accordance with our goal to contribute to improving the integrity of FHA single-family insurance programs.

Our audit objective was to determine whether the U.S. Department of Housing and Urban Development (HUD) paid ineligible preforeclosure sale claims that did not meet the net sales proceeds requirements.

What We Recommend

We recommend that the Deputy Assistant Secretaries for Single Family Housing and Finance and Budget develop and implement controls to ensure that preforeclosure claims comply with the program's net sales proceeds requirements, including procedures to (1) implement controls to ensure that lenders comply with the preforeclosure program minimum sales proceeds requirements, (2) evaluate the reliability of lender-provided claim data, (3) immediately discontinue the practice of approving variance requests without a valid documented justification, and (4) implement controls to evaluate the quality of preforeclosure sale claim property valuations.

What We Found

Of 95 statistically selected claims paid from September 1, 2011, through November 30, 2012, 47 did not meet the minimum net sales proceeds criteria or were approved based upon variances without a documented justification. HUD paid ineligible preforeclosure sale claims because it did not design adequate controls to ensure that lenders complied with the minimum net sales proceeds requirements. HUD's controls were inadequate to (1) correctly determine the required minimum proceeds amount, (2) ensure that variance approvals were consistent with the program's objectives, (3) ensure the quality of appraisals used to establish minimum net sales proceeds amounts, and (4) ensure the reliability of lender-provided claim data.

By projecting our sample results, we estimate that HUD paid more than $404 million in claims for 4,457 preforeclosure claims that did not meet the program requirements. Sales proceeds were deficient in these cases by an estimated amount of $8.62 million. The ultimate cost to the FHA insurance fund associated with the $404 million in ineligible claims is not known because loss amounts (if any) for each loan would have varied depending on how the loan default was otherwise resolved if the program rules were followed. At a minimum, claim losses would have been reduced by the $8.62 million in deficient proceeds if HUD required the appropriate proceeds amount based upon documented competitive marketing periods.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) provides mortgage insurance on home loans made by its approved lenders. This insurance is paid for by borrowers and provides lenders with protection against losses if the homeowner defaults on the loan. Lenders may submit an insurance claim to HUD for losses incurred if a property is foreclosed upon; however, the lender must first attempt to work with the homeowner and consider options available as part of HUD's loss mitigation program, which can assist the borrower in bringing the loan current or allow the borrower to dispose of the home without foreclosure. HUD's single-family Preforeclosure Sales Program is one option under HUD's loss mitigation program.

The Preforeclosure Sales Program allows an FHA borrower in default (resulting from an adverse and unavoidable financial situation) to sell his or her home at fair market value and use the sales proceeds to satisfy the mortgage debt, even if the proceeds are less than the amount owed. This program is appropriate for borrowers whose financial situation requires that they sell their home but who are unable to do so without FHA relief because the gross recovery on the sale of the property is less than the amount owed on the mortgage. After the property is sold, lenders submit an FHA insurance claim and are compensated for the difference between the sales proceeds and the amount owed on the mortgage (including accrued interest and reimbursable costs). Lenders are required to ensure that the borrower and property meet the program requirements specified in HUD Mortgagee Letter 2008-43,[1] Preforeclosure Sales Program – Utilizing the Preforeclosure Sale Loss Mitigation Option to Assist Families Facing Foreclosure, issued December 24, 2008. These criteria require lenders to ensure that a minimum proceeds amount is obtained from the property sale based on the length of time a property was competitively marketed for sale. The intent of this requirement was to limit HUD's losses and reduce the possibility of program abuse.

From September 1, 2011, through November 30, 2012, FHA paid 45,378 preforeclosure sale claims totaling more than $4 billion. HUD's Claims Branch administers the preforeclosure claim process, and its Post Insurance Division conducts quality control reviews for a sample of claims paid. HUD's National Servicing Center administers a variance process that allows lenders to request an exception to the program's requirements.

Our audit objective was to determine whether HUD paid ineligible preforeclosure sale claims that did not meet the net sales proceeds requirements.

[1] See appendix D.

RESULTS OF AUDIT

Finding: FHA Paid More Than $404 Million in Ineligible Claims for Approximately 4,457 Preforeclosure Sale Claims That Did Not Meet Minimum Net Sales Proceeds Requirements

HUD paid claims for approximately 4,457 ineligible preforeclosure sale claims totaling an estimated $404 million[2] that did not meet the program requirements or were approved based upon variances without a documented justification. HUD paid ineligible preforeclosure sale claims because its controls were not properly designed to (1) correctly determine required minimum sales proceeds amounts, (2) ensure that variance approvals were consistent with the program objectives, (3) ensure the quality of appraisals used to establish the minimum sales proceeds amounts, and (4) ensure the reliability of lender-provided claim data. As a result, the FHA insurance fund incurred and remained at risk for unnecessary losses.

HUD Did Not Correctly Determine Required Minimum Sales Proceeds Amounts

FHA paid preforeclosure sale claims that did not meet the sales proceeds criteria and were, therefore, not eligible in accordance with the program requirements. We reviewed a statistical sample of 95 preforeclosure sale claims paid from September 1, 2011, through November 30, 2012, to determine whether the claims met HUD's minimum sales proceeds requirements. Of the 95 files reviewed, 35, or 37 percent, did not meet the program's net proceeds criteria based upon the actual competitive marketing period under the program and were, therefore, not eligible.

Calculation of Net Sales Proceeds

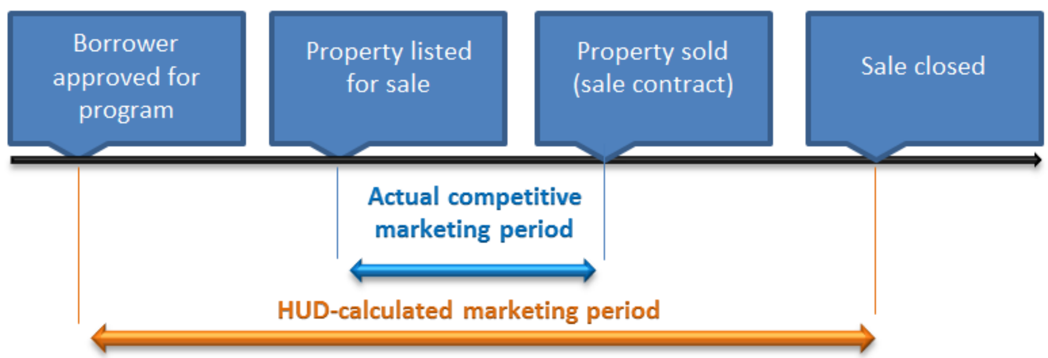
HUD's automated claim processing system and postclaim quality control review process did not correctly calculate or verify required minimum preforeclosure sales proceeds amounts. HUD Mortgagee Letter 2008-43 stated that the minimum required proceeds amount for preforeclosure sales was based on the length of time a property was competitively marketed for sale. For the first 30 days of marketing under the program, lenders were permitted to approve only offers that would result in sales proceeds totaling at least 88 percent of a property's appraised value. For the next 30 days of competitive marketing, required proceeds were 86 percent of the appraised value, and thereafter, required proceeds were 84 percent of the appraised value. HUD implemented these

[2] See Scope and Methodology for details of our projections.

requirements, in part, as a result of a prior Office of Inspector General (OIG) audit (audit report number 2005-LA-0001), which found that investors had abused the preforeclosure program and obtained properties below fair market value. By limiting property sale amounts based upon how long properties were actively marketed, for example, through an active listing with a real estate agent, these rules could limit HUD's program losses by reducing the risk of program abuse and increasing the likelihood that preforeclosure property sales would occur at or near fair market value as intended.

Incorrect Net Sales Proceeds

HUD's claim payment system and postclaim review process did not include controls to properly enforce the minimum sales proceeds requirements. HUD did not accurately determine how long properties were competitively marketed for sale and, accordingly, which of the minimum sales proceeds percentage requirements was applicable. Without consideration for the actual competitive marketing period, HUD calculated the minimum required proceeds based upon the number of days elapsed from the borrower's acceptance into the preforeclosure program to the property sale closing date. This calculation was not consistent with the mortgagee letter requirements or the intent of these requirements because it often overestimated the actual marketing period under the program. The following diagram represents, in general terms, the difference between the actual competitive marketing period under the program and the calculation used by HUD.



For example, for 1[3] of the 95 sample claims reviewed, the borrower executed a sales contract before entering the program and therefore, marketed the property for zero days under the program; however, HUD incorrectly calculated the marketing period as 170 days because the closing did not occur until months later. Based on the actual marketing period under the program (less than 30 days), required sale proceeds should have been 88 percent of the appraisal value, yet HUD paid the claim with proceeds totaling only 84 percent.

HUD used incorrect dates to calculate the sales proceeds requirements because it did not properly design controls to enforce the program requirements. HUD's

[3] Loan 095-5849645

automated claim processing system did not collect information necessary to determine how long properties were marketed. For example, the automated claim system did not track when properties were listed for sale, when sales contracts were signed, or when borrowers otherwise ceased accepting competitive offers. Additionally, HUD's postclaim review process did not include an evaluation of claim file information, such as listing broker documentation, to determine the actual competitive marketing period.

An official from HUD's National Servicing Center stated that lenders were advised of HUD's sales proceeds calculation methodology, which relied on borrower approval and sale closing dates. Because this calculation did not consider the actual competitive marketing period, the program's sales proceeds requirement could easily be circumvented by scheduling closing dates to accommodate HUD's enforcement policy.

HUD's Controls Over Preforeclosure Claim Variances Were Not Adequate

FHA paid preforeclosure sale claims based on variances that were not adequately documented. Our review of 95 statistically selected preforeclosure sale claims paid from September 1, 2011, through November 30, 2012, found that 12, or 12.6 percent, of these property sales were approved based upon an unjustified variance. Five of these twelve claims involved an exception to the program's partial claim requirements.

Variance Process

HUD administers a variance process that allows lenders to request an exception to the preforeclosure program requirements based upon a valid justification. Variance requests can include minor items such as appraisal expiration date extensions or more significant exceptions that result in substantially higher claim amounts than permitted under the program requirements. Variances are submitted electronically and documented through HUD's Extension and Variance Automated Requests System (EVARS) and employees at HUD's National Servicing Center are responsible for reviewing these requests. EVARS includes a field for documenting HUD's approval or denial of variance requests and a field for documenting comments made by the HUD reviewer regarding the review decision. Based upon variance data provided by HUD's National Servicing Center, HUD approved 1 or more variance requests for 27,455 (60.5 percent) of the 45,378 of the preforeclosure claims paid during our audit period from September 1, 2011, through November 30, 2012.

Inadequate Variance Controls

HUD did not have adequate controls to ensure that variance approvals were consistent with the program objectives. HUD's variance request form required lenders to provide a written justification documenting the reason an exception to the program requirements was appropriate. However, HUD did not always require a specific justification when approving variance requests for insufficient net sales proceeds, particularly those involving partial claim notes due to HUD. Mortgagee Letter 2008-43 required that the outstanding balance on a partial claim note (unpaid subordinate mortgage) be deducted when calculating the required minimum net sales proceeds. However, as a practice, HUD approved lender variance requests to exclude partial claim amounts from the net proceeds calculation without requiring a specific justification[4] documenting the basis for excluding the partial claim. For net sales proceeds variances without a documented justification, including those involving partial claims, EVARS also did not document the basis for HUD's approval decision or demonstrate that the approval was consistent with the program objectives.

For example, HUD approved sales proceeds variance requests based on the justifications below, which stated only "approval to pay partial claim in the amount of $10,073.15" and "please review to accept $137,598 min net proceeds." These variance requests indicated that the program requirements were not met yet did not explain why an exception should be made. In these cases, the variance form did not document the basis for HUD's variance approval decision or demonstrate that the approval was consistent with the program objectives.

Example 1

Justification for requesting HUD approval of this variance from customary Pre-foreclosure Sale procedure: Chase#1952819153 Submitting for variance approvals. 1)need appraisal ext as the appraisal expire on 5/19/12 need ext thru 7/31/12. 2) Requesting approval for $4440.00 in closing cost. 3) approval to pay partial claim in the amount of $10,073.15. Thank you

Example 2

Justification for requesting HUD approval of this variance from customary Pre-foreclosure Sale procedure: please review to accept $137,598 min net proceeds and to allow $4650 seller concessions, ATP approved 11/28/11. Thanks!

This condition occurred because HUD did not design adequate controls such as written procedures or criteria that could be systematically applied to ensure that variance approvals were consistent with the program objectives and adequately documented to support variance review decisions. Without these controls, HUD did not have sufficient information available for management or audit review to determine whether the granted variances were appropriate. Additionally, HUD did not have adequate assurance that the variance process appropriately limited program losses and restricted opportunities for program fraud or abuse.

[4] HUD's National Servicing Center stated that variances involving partial claims were approved for loans that would otherwise meet the minimum proceeds requirements but for the partial claim amount.

Estimated Ineligible and Excessive Claims Totaled at Least $404 Million

By projecting our sample results, including 35 claims that did not meet the minimum sales proceeds criteria and 12 that were approved based upon unjustified variances, to the universe of 11,063 claims,[5] we estimated that FHA paid at least $404 million in claims for 4,457 preforeclosure sale claims with insufficient sales proceeds during our audit period. Net sales proceeds were deficient in these cases by an estimated amount of $8.62 million.[6]

HUD's Controls Over Preforeclosure Property Valuations Were Not Adequate

HUD did not have adequate controls in place over preforeclosure sale claim appraisals used to determine required minimum preforeclosure sales proceeds amounts. Mortgagee Letter 2008-43 required that lenders obtain an appraisal to ensure that preforeclosure program properties were sold at or near fair market value. It also stated that HUD performs appraisal monitoring reviews, subject to the imposition of sanctions for appraisal deficiencies that do not meet HUD's requirements.

HUD did not implement controls to enforce the program's appraisal requirements and ensure the quality of appraisals used to establish the minimum proceeds amounts. After a HUD OIG audit issued in 2005 (audit report number 2005-LA-0001) found that HUD lacked controls over preforeclosure program appraisals, HUD implemented an appraisal review process that was administered by a contractor. However, in approximately 2007, HUD discontinued the appraisal review contract and did not implement a similar control. Because HUD did not have controls for evaluating the quality and reliability of appraisals, it did not have appropriate assurance that preforeclosure program property valuations were appropriate. Accordingly, HUD's risk of losses associated with improper valuations increased.

Because the scope of our audit did not include a complete review of property appraisals and data were not available to estimate appraisal deficiencies, our audit results do not include an estimate of the potential impact of this control deficiency. We recommend that HUD evaluate the risk associated with unchecked appraisals and implement appropriate controls sufficient to ensure that preforeclosure program property valuations are appropriate. HUD officials stated

[5] See Scope and Methodology for details of our projections.

[6] OIG typically reports estimated cost savings for a one year period. The $8.62 million in deficient proceeds identified is based on the audit sample, which covered a 15 month period, was proportionally adjusted to $6.9 million, reflecting the estimated savings for a 12 month period. See appendix A.

that they had preliminary plans to develop a new method for estimating preforeclosure property values that, if designed and implemented effectively, could address this deficiency.

HUD's Controls Over Claim Submission Data Reliability Needs Improvement

HUD's automated claim processing system did not include controls to verify the reasonableness of lender claim form entries pertinent to the minimum required sales proceeds calculation. For example, HUD did not have system edits to identify an appraisal value entry error of $20,000 instead of $200,000. As a result, it did not have appropriate assurance that claim amounts were properly determined based upon accurate information. We reviewed a targeted, nonrepresentative sample of 25 preforeclosure claims paid during the audit period from September 1, 2011, through November 30, 2012, to determine whether dates or amounts related to HUD's minimum sales proceeds calculation were correctly reported. The samples selected for review exhibited unusual claim form dates or amounts. Of the 25 sample claims, 17 were paid despite reported values that appeared unreasonable. The errors identified through the audit testing resulted primarily in apparent claim underpayments; however, the identified control deficiency may have resulted in excessive or ineligible claims that were not identified by our limited testing. The results demonstrate that HUD's claim payment system did not include basic application controls to validate the reasonableness of claim form values pertinent to the minimum sales proceeds calculation, a key factor in determining claim eligibility and amounts.

Conclusion

FHA paid approximately 4,457 ineligible preforeclosure sale claims totaling an estimated $404 million that did not meet the program requirements or were approved based upon variances without a documented justification. This condition occurred because HUD did not design program controls to ensure compliance with program requirements. HUD needs to strengthen its controls to ensure that the program objectives are met and that it pays only eligible preforeclosure sale claims that met the sales proceeds requirements.

Recommendations

We recommend that the HUD Deputy Assistant Secretaries for Single Family Housing and Finance and Budget[7]

1A. Design and implement controls to ensure that lenders comply with the preforeclosure program minimum sales proceeds requirements to put $6,898,518[8] to better use. These controls should include procedures to correctly determine the competitive marketing period in accordance with Mortgagee Letter 2008-43 and ensure that variance requests are evaluated and approved only with a valid documented justification.

1B. Evaluate the risk associated with HUD's claim system controls over data reasonableness and consider additional measures to address this risk. HUD should consider implementing an application system control to identify unreasonable claim form entries pertinent to the minimum sales proceeds calculation.

We also recommend that the HUD Deputy Assistant Secretary for Single Family Housing

1C. Immediately discontinue the practice of approving variance requests without a valid documented justification.

1D. Design and implement controls to evaluate the quality of preforeclosure sale claim property valuations and detect or prevent possible program abuse involving undervaluation.

---

[7] The recommendations do not specifically follow the order in which the deficiencies appear in the audit report to better address the recommendations to the appropriate action officials.

[8] The $8.62 million in deficient proceeds identified is based on the audit sample, which covered a 15 month period, was proportionally adjusted to $6.9 million, reflecting the estimated savings for a 12 month period. See appendix A.

SCOPE AND METHODOLOGY

We performed our audit work between November 2012 and July 2013. We conducted audit fieldwork at the Phoenix Office of Audit. The audit generally covered HUD's procedures in place for preforeclosure claims paid from September 1, 2011, through November 30, 2012. To accomplish our audit objective, we

- Interviewed HUD officials from HUD's Office of Single Family Housing, Claims Branch, Post Insurance Division, and National Servicing Center.
- Reviewed Preforeclosure Sales Program records maintained by HUD.
- Obtained and reviewed preforeclosure sale claim data from HUD's Single Family Data Warehouse.
- Evaluated HUD's controls over Preforeclosure Sales Program requirements to determine whether ineligible or excessive claims may have been paid.
- Reviewed a targeted, nonrepresentative sample of 25 preforeclosure claims paid during the audit period from September 1, 2011, through November 30, 2012, to determine whether dates or amounts related to the HUD's net sales proceeds calculation were correctly reported.
- Selected and reviewed a statistical sample of 95 preforeclosure claims paid from September 1, 2011, through November 30, 2012, to determine whether the claims met HUD's minimum sales proceeds requirements.

From September 1, 2011, through November 30, 2012, HUD paid 45,378 preforeclosure sale claims totaling more than $4.0 billion.[9] The nine lenders with the highest volume of preforeclosure sales submitted more than 87 percent of these claims. When designing the audit statistical sample, we limited the sample universe to these top nine lenders. We included only claims that had a reported net sales proceeds amount that was less than 88 percent of the reported appraisal value and claims reporting that more than 30 days elapsed between the borrowers' program participation approval date and closing date. The audit universe for the statistical sample included 11,063 claims totaling more than $1 billion. We relied in part on data maintained by HUD in its Single Family Data Warehouse database to identify preforeclosure claims paid during our audit period and the associated claim amounts. Although we did not perform a detailed assessment of the reliability of the data, we determined that the computer-processed data were sufficiently reliable for our purposes. The HUD system data for the sampled items were validated by reviewing documents supplied by the sampled lenders.

[9] We did not select claims before September 1, 2011, for our sample universe because a recent HUD OIG audit, audit report number 2012-KC-0004, included statistical sample testing to evaluate preforeclosure sale claim borrower eligibility for this period.

A stratified systematic sample of 95 claims was identified for auditing among 14 strata of the audit universe. Additionally, to control for the possibility that preforeclosure sale claims were adversely affected differently across real estate markets, each claim was assigned a real estate market change indicator, and within each of the 14 strata, a sort was performed on this indicator. The sample design was stratified as shown in the table below.

Strata design				
Strata	**Preforeclosure claims**	**Sampling size**	**Probability of selection**	**Sampling weight**
Group 1a	281	2	0.007117	140.50
Group 1b	303	3	0.009901	101.00
Group 2a	881	8	0.009081	110.13
Group 2b	876	7	0.007991	125.14
Group 2c	879	7	0.007964	125.57
Group 2d	875	7	0.008000	125.00
Group 2e	882	8	0.009070	110.25
Group 3a	515	4	0.007767	128.75
Group 3b	524	4	0.007634	131.00
Group 4a	1,006	9	0.008946	111.78
Group 4b	1,015	9	0.008867	112.78
Group 4c	1,009	9	0.008920	112.11
Group 4d	1,007	9	0.008937	111.89
Group 4e	1,010	9	0.008911	112.22
Total	**11,063**	**95**	**N/A**	**N/A**

We reviewed the statistical sample of preforeclosure sale case files to evaluate whether the claims met the preforeclosure program net sales proceeds criteria. Marketing periods for the preforeclosure program were determined based on documentation provided by the associated lenders. The marketing period start date was determined as the first day the property was listed for sale after the borrower was approved for participation in the preforeclosure program. The competitive marketing period end date was determined based upon the date the ultimate buyer and seller executed a sale contract, unless the sale contract specified that competitive offers could be accepted after the contract date or there was evidence provided indicating that competitive marketing continued after the contract date. It is possible that some form of marketing could have occurred after the sale contract date in some cases, however, for the noted exceptions, there was no evidence such as additional offers or real estate broker documentation to support that this occurred. We calculated the net sales proceeds deficiency amounts by subtracting the actual net proceeds from the appropriate percentage (84,86 or 88 percent) of the appraised value, based upon the actual marketing period duration. There were four spares used, and they were taken from their respective strata. Hence, no sampling weights had to be recalculated. The preforeclosure claims that did not meet the program requirements were documented by the amount of claim that was overpaid based on the program requirement that was not met, either by the amount of deficient proceeds based on the correct marketing time or by the amount of deficient proceeds based on inadequate variance approvals by HUD.

Our sample was designed using stratification to ensure that the minor differences observed in the marketing timeframe and unjustified variances were detectable and projectable. Since our method of stratification tended to capture the changes unique to local market value, our sample design also had a meaningful ability to control for the variability inherent in the claim amount paid by FHA. Hence, our sample design gave us an acceptably precise projection of the total claims amount attributable to loans with these defects. Additional testing was conducted on this premise, and it was found that this sample design conformed to the stated confidence intervals and did not carry the unnecessary risk of a spurious error.

U*niverse projection:* $15,714,919.91 – 1.664 × $4,262,179.31 = **$8,623,148.32**
Claims affected: 5,404.49 – 1.664 × 569.27= **4,457.3**
Total claim projection: $503,316,952.40 – 1.664 × $59,575,724.32 = **$404,189,863.10**

The projection amounts were computed based on the sampling results and extended to the population. Based on this computation, we found that 47 of 95 statistically selected claims paid did not meet the minimum net sales proceeds criteria (35) or were approved based upon variances without a documented justification (12). This amounts to an average of $1,420 per claim paid. Deducting for statistical variance to accommodate the uncertainties inherent to statistical sampling, we can say, with a one-sided confidence interval of 95 percent, that the average amount per claim was $779. Extrapolating this to the 11,063 preforeclosure claims in the audit universe, we can say at least $8.62 million in funds was paid on claims that did not meet program requirements, and it could be more. Additionally, this defect was found across many preforeclosure claims, and we can also say, with a one-sided confidence interval of 95 percent, that at least 4,457 claims in our universe were affected valued at $404 million, and it could be more. The $8.62 million in deficient proceeds identified is based on the audit sample, which covered a 15 month period, was proportionally adjusted to $6.9 million, reflecting the estimated savings for a 12 month period (see appendix A).

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 findings and conclusions 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:

- Controls over minimum net sales proceeds requirements.
- Controls over variance evaluations and approvals.
- Controls over property valuations.
- Controls over data reliability and reasonableness.

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 Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- HUD did not have adequate controls to ensure that preforeclosure claims met the program's minimum sales proceeds requirements (finding).
- HUD did not have adequate controls to ensure that preforeclosure sale claim variances were adequately evaluated and approved (finding).

- HUD did not have adequate controls to ensure the quality of preforeclosure sale claim property valuations and detect or prevent possible program abuse involving undervaluation (finding).
- HUD did not have adequate controls to ensure data reliability and reasonableness (finding).

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$6,898,518
	$6,898,518

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Funds to be put to better use for recommendation 1A represent the amount of deficient net sales proceeds found based upon the statistical sample results. In this instance, if HUD implements our recommendations, it will ensure that preforeclosure sale claims are paid only for eligible sales that meet the sales proceeds requirements, and it will prevent payment of future ineligible claims. Our estimate reflects only the initial year of this benefit. The $8,623,148 amount of deficient proceeds identified based on the audit sample, which covered a 15 month period, was proportionally adjusted to reflect the estimated savings for a 12 month period.

Monthly deficient proceeds: $8,623,148 ÷ 15 months = **$574,876.53**
12 month estimate: $574,876.53 × 12 months = **$6,898,518.40**

Also, although we determined that the claim amounts paid were ineligible because the claims did not meet the program requirements, to be conservative, we estimated the future savings based only on the portion of the ineligible claim associated with the amount of deficient sales proceeds. For example, if an $80,000 ineligible claim paid had net sales proceeds that were deficient by $250, our estimate projects a savings based only on $250. The estimated amount does not include potential offsetting costs incurred by HUD to implement our recommendations to strengthen controls.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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

OFFICE OF HOUSING

AUG 2 0 2013

MEMORANDUM FOR: Tanya E. Schulze, Regional Inspector General for Audit, Los Angeles Region, 9DGA

FROM: Kathleen Zadareky for Charles S. Coulter, Deputy Assistant Secretary for Single Family Housing, HU

Monica A. Clarke, Deputy Assistant Secretary for Finance and Budget (Acting), HW

SUBJECT: FHA Pre-Foreclosure Sales (PFS) Program

Thank you for providing the Office of Single Family Housing (OSFH) and the Office of Finance and Budget the opportunity to comment on the Office of Inspector General's (OIG) draft audit report entitled *FHA Preforeclosure Sales Program* (2013-LA-000X). Please find our comments below:

Recommendation 1A:

Design and implement controls to ensure that lenders comply with the pre-foreclosure program minimum sales proceeds' requirements to put $6.8 million to better use. These controls should include procedures to correctly determine the competitive marketing period in accordance with Mortgagee Letter 2008-43 and ensure that variance requests are evaluated and approved only with a valid documented justification.

OSFH's Response:

Comment 1

The Office of Single Family Housing will partner with the Office of the FHA Comptroller, which owns the Single Family Claims system, to review the thresholds established for minimum net pre-foreclosure sales proceeds and perform a cost benefit analysis for alternative criteria. Currently, the Single Family Claims system uses information available through the claim submission process to determine the net pre-foreclosure sales proceeds and adjusts the claim amount if it is not met. Notwithstanding the foregoing, FHA will attempt to leverage its Quality Assurance Division (QAD) to ensure that a sample of a lender's PFS transactions are reviewed to ensure the minimum net sales proceeds were actually met and are documented in the lenders' servicing files. This will be achieved through periodic reviews conducted by QAD.

Comment 2

With respect to the OIG's assertion that variance requests are evaluated and approved without valid documented justifications, OSFH evaluates and only approves variance requests that meet its existing criteria delineated in the instructions provided to the OIG by the National Servicing Center.

www.hud.gov espanol.hud.gov

Comment 3

Comment 4

Comment 5

Comment 6

Recommendation 1B

Evaluate the risk associated with HUD's claim system controls over data reasonableness and consider additional measures to address this risk. HUD should consider implementing an application system control to identify unreasonable claim form entries pertinent to the minimum sales proceeds calculation.

OSFH's Response:

The Office of Single Family Housing will partner with the Office of the FHA Comptroller, which owns the Single Family Claims system, to evaluate the risk associated with HUD's claim system controls over data reasonableness and consider additional measures to address this risk.

Recommendation 1C

Immediately discontinue the practice of approving variance requests without a valid documented justification.

OSFH's Response:

As mentioned above, OSFH evaluates and only approves variance requests that meet its existing criteria delineated in the instructions provided to the OIG by the National Servicing Center. However, OSFH is expanding its instructions to include additional documents, recommended by the OIG.

With respect to the recommendations on variances and minimum sale price, it is important to note that, under FHA's new loss mitigation waterfall and FHA Home Affordable Modification Program (FHA-HAMP) guidelines, Partial Claim amounts have increased to up to 30 percent of the average loan's unpaid principal balance (UPB). The Partial Claim amount factors into and lowers the net sales proceeds from the pre-foreclosure sale, potentially below the minimum amount required, and thus, leads to more variance requests in connection with such sales. Although, as mentioned above, FHA is revising its variance request procedures, limiting or reducing variance approvals potentially leads to fewer pre-foreclosure sales' transactions being completed. This ultimately has a negative impact on the Mutual Mortgage Insurance (MMI) Fund.

Recommendation 1D

Design and implement controls to evaluate the quality of pre-foreclosure sale claim property valuations and detect or prevent possible program abuse involving undervaluation.

OSFH's Response:

FHA's recently-published PFS Mortgagee Letter (ML 2013-23) established controls that require the use of a Broker's Price Opinion (BPO) or Automated Valuation Model (AVM) to substantiate the appraised value used for PFS transactions. In certain cases, servicers are required to request a variance in order to proceed. Specifically, cases requiring variances are those where: (1) the current appraised value of the property is less than the UPB by an amount of $75,000 or greater;

Comment 6

(2) the appraised value is less than 50 percent of the UPB; or (3) the BPO or AVM is not within 10 percent of the "as-is" appraised value. In addition, as referenced above, FHA will attempt to leverage its Quality Assurance Division to ensure that a sample of a lender's PFS transactions are reviewed to evaluate the quality of the property valuations associated with such transactions to help detect or prevent possible program abuse involving under-valuation. This will be achieved through periodic reviews conducted by QAD. During such reviews, auditors will have procedures which require them to also use of other valuation tools such as AVMs and BPOs to help validate the accuracy of appraisals used for PFS transactions.

OIG Evaluation of Auditee Comments

Comment 1 HUD stated it will reevaluate its minimum net sales proceeds criteria and utilize its Quality Assurance Division to review a sample of preforeclosure claims to ensure the minimum net sales proceeds requirements were met.

HUD's intention to implement additional controls over preforeclosure claims is consistent with OIG audit report recommendation 1A. However, we note that any planned corrective actions should be sufficient to ensure that lenders correctly determine preforeclosure competitive marketing periods in accordance with Mortgagee Letter 2008-43. As noted in the audit report, HUD's automated claim processing system (Single Family Claim's system) and post-claim quality control review process did not correctly calculate or verify required minimum preforeclosure sales proceeds amounts. Additionally, HUD advised lenders of its net sales proceeds calculation methodology that did not consider the actual competitive marketing period. HUD should design controls to directly address these deficiencies.

Comment 2 With respect to approval of variance requests, HUD appeared to disagree with the audit report and stated it evaluates and approves variance requests to meet its existing criteria delineated in instructions provided to the OIG.

As stated in the audit report, we found HUD did not design adequate controls such as written procedures or criteria that could be systematically applied to ensure that variance approvals were consistent with the program objectives and adequately documented to support variance review decisions. During the audit, the Director of Servicing and Loss Mitigation at HUD's National Servicing Center, who also reviewed variance requests, indicated he was not immediately familiar with any review criteria or guidance other than Mortgagee 2008-43 which does not include criteria or review procedures for the variance process. He later provided a one page document that listed six factors that could cause a sale to result in low net sales proceeds. For example, the document listed "States with large property taxes" and "payment of a partial claim". The document did not establish appropriate standards, thresholds or documentation requirements for the variance review process. Furthermore, we note that our review of 95 statistically selected preforeclosure sale claims found that 12, or 12.6 percent, of these property sales were approved based upon variances without a documented justification.

Comment 3 HUD did not disagree with the audit report recommendation 1B and stated it will evaluate the risk associated with HUD's claim system controls over data reasonableness and consider additional measures to address the risk. This response indicates agreement with OIG audit report recommendation 1B and therefore we concur with this response.

Comment 4 HUD stated it only approves variance requests that meet criteria delineated in instructions that were provided to OIG, yet will "expand its instructions" based on the OIG audit recommendation.

We agree that additional procedures are needed to provide adequate controls over the variance process. However, as explained above in comment 2 and the audit report, HUD did not design adequate controls such as written procedures or criteria that could be systematically applied to ensure that variance approvals were consistent with the program objectives and adequately documented to support variance review decisions. During the audit, the Director Servicing and Loss Mitigation at HUD's National Servicing Center was not immediately familiar with any additional review process guidance and the referenced document later provided did not include criteria or documentation requirements for the variance review process.

Comment 5 HUD noted that partial claim amounts have increased due to recent loss mitigation program changes and that this has led to more variance requests within the preforeclosure program. HUD also noted that limiting or reducing variance approvals has a negative impact on the Mutual Mortgage Insurance Fund.

As explained in the OIG audit report finding, HUDs decision to routinely provide variances excluding partial claims amounts from the preforeclosure program net sales proceeds calculation was not consistent with the program requirements specified in Mortgagee Letter 2008-43 which require that such amounts be deducted. Regarding HUD's assertion that limiting variance approvals results in increased losses, we note that, in our opinion, removing certain restrictions for partial claim amounts could encourage abuse of the partial claim program and provides additional incentives for borrowers to take advantage of the claim process rather than seek alternatives that could be far less costly to HUD. While preforeclosure claim losses may be slightly lower overall relative to conveyance claims due to various factors, such as limiting participation to properties that have not been abandoned etc…, this does not necessarily mean that reducing existing preforeclosure program restrictions will result in lower total losses.

Comment 6 HUD stated that FHA recently implemented controls over preforeclosure property valuations that require lenders to obtain a broker price opinion or automated valuation estimate and obtain HUD approval if these secondary valuations indicate a value outside certain thresholds. HUD also stated its Quality Assurance Division will review a sample of preforeclosure sale transactions and utilize automated valuation models and broker price opinions to help validate the accuracy of appraisals.

We agree that additional controls over preforeclosure claim valuations are necessary. We note that any planned corrective actions should be sufficient to provide adequate assurance that preforeclosure valuations are being performed and documented in accordance with the program requirements and to detect and prevent possible program abuse involving undervaluation. For example, the appraisal reviewers should have adequate proficiency to determine compliance with the preforeclosure program appraisal requirements specified in HUD Handbook 4150.2 (Valuation Analysis for Single Family One-to Four-Unit Dwellings). These reviews should be performed on an adequate number of preforeclosure claims and provide a sufficient basis to hold mortgagees accountable for the quality of appraisals. Additionally, the appraisal review results should be adequately documented and reviewed by management to evaluate overall appraisal compliance for the program.

Appendix C

SCHEDULE OF DEFICIENCIES

Sample item number	Ineligible claims based on program marketing duration	Excessive claim amount	Ineligible claims based on inadequate variance approvals	Excessive claim amount	Total claim amount
1	X	$ 1,360.00		$ -	$ 81,893.85
2		-		-	83,363.54
3	X	1,147.92		-	77,290.39
4		-	X	3,115.51	162,764.70
5	X	8,520.00		-	43,816.06
6		-		-	116,713.49
7		-		-	83,358.19
8	X	987.70		-	61,662.73
9		-	X	3,739.72	125,222.44
10	X	226.40		-	17,834.83
11	X	389.28		-	139,367.36
12		-		-	108,315.66
13		-		-	134,518.92
14		-		-	94,373.91
15		-		-	261,097.56
16		-		-	128,582.41
17		-		-	73,870.08
18		-		-	154,011.00
19		-		-	80,755.87
20		-	X	4,950.72	82,648.80
21		-		-	114,101.12
22		-		-	61,750.37
23		-		-	208,945.39
24		-		-	144,130.88
25		-		-	69,140.16
26		-	X	2,517.28	102,241.20
27		-		-	130,537.46
28		-		-	22,900.12
29		-		-	69,920.00
30		-	X	1,707.85	102,360.96
31		-		-	25,459.77

Sample item number	Ineligible claims based on program marketing duration	Excessive claim amount	Ineligible claims based on inadequate variance approvals	Excessive claim amount	Total claim amount
32	X	714.4		-	200,660.97
33	X	274.65		-	54,024.41
34	X	790.20		-	82,032.30
35	X	1,841.53		-	155,955.32
36		-		-	105,410.40
37	X	1,103.40		-	54,264.17
38	X	1,918.73		-	141,564.03
39		-		-	205,316.35
40	X	498.31		-	148,732.67
41		-		-	103,658.60
42	X	1,367.00		-	95,704.40
43		-		-	108,545.67
44	X	281.38		-	116,784.40
45		-		-	121,703.69
46		-	X	1,394.20	79,382.34
47		-		-	132,512.64
48		-		-	45,623.52
49	X	1,120.00		-	97,555.29
50		-		-	53,498.02
51		-		-	52,285.76
52	X	886.92		-	81,014.86
53		-		-	131,821.28
54	X	856.69		-	128,088.61
55	X	685.63		-	53,663.03
56	X	434.80		-	72,152.29
57	X	631.97		-	103,145.23
58		-		-	121,417.40
59		-	X	5,761.21	149,670.38
60	X	401.62		-	95,382.47
61		-	X	10,169.32	46,481.99
62	X	580.83		-	85,564.70
63	X	2,600.00		-	55,757.08
64		-	X	6,997.75	116,511.66
65		-		-	84,571.12
66		-		-	30,509.27
67	X	3,287.15		-	89,054.91

Sample item number	Ineligible claims based on program marketing duration	Excessive claim amount	Ineligible claims based on inadequate variance approvals	Excessive claim amount	Total claim amount
68		-	X	3,963.30	52,031.77
69		-		-	217,240.99
70		-		-	23,499.95
71		-		-	129,590.59
72		-		-	61,339.42
73		-		-	207,286.86
74	X	1,810.95		-	47,162.76
75	X	1,643.15		-	48,100.62
76	X	3,192.21		-	125,878.02
77		-	X	4,975.18	163,550.76
78		-		-	48,220.37
79		-	X	30,800.00	95,364.61
80		-		-	71,377.81
81		-		-	25,195.24
82	X	1,700.00		-	108,833.84
83		-		-	90,002.80
84		-		-	44,604.57
85		-		-	55,126.74
86	X	250.15		-	161,930.73
87	X	2,607.88		-	72,272.13
88	X	45.18		-	33,050.34
89	X	1,349.90		-	30,557.38
90	X	2,853.18		-	124,184.04
91	X	2,440.00		-	30,280.66
92		-		-	131,082.36
93		-		-	27,119.83
94		-		-	28,980.40
95		$ -		$ -	$ 126,841.86
Totals	**35**	**$ 50,799.11**	**12**	**$ 80,092.04**	**$ 9,143,677.90**

Appendix D

CRITERIA

Mortgagee Letter 2008-43: Preforeclosure Sale Program – Utilizing the PFS Loss Mitigation Option to Assist Families Facing Foreclosure

Preforeclosure Sale Introduction

The Pre-Foreclosure Sale (PFS) option allows mortgagors in default (resulting from an adverse and unavoidable financial situation) to sell their home at FMV [fair market value] and use the sales proceeds to satisfy the mortgage debt even if the proceeds are less than the amount owed. This option is appropriate for mortgagors whose financial situation requires that they sell their home, but they are unable to do so without FHA relief because the gross recovery on the sale of their property (i.e., sales price minus sales expenses) is less than the amount owed on the mortgage. HUD's home retention alternatives such as Special Forbearance, Mortgage Modification, or Partial Claim must first be considered and determined unlikely to succeed due to the mortgagor's financial situation. Mortgagees must maintain supporting documentation to demonstrate that a comprehensive review of the mortgagor's financial records was completed, and that the mortgagor did not have sufficient income to sustain the mortgage. Under no circumstances shall the PFS option be made available to mortgagors who have abandoned their mortgage obligation despite their continued ability to pay.

To participate in the program, mortgagors must be willing to make a commitment to actively market their property for a period of 3 months, during which time the mortgagee delays foreclosure action. Mortgagors who successfully sell to a third party within the required time may receive a cash consideration of up to $1,000. Mortgagees also receive a $1,000 incentive for successfully avoiding the foreclosure and complying with all the requirements of this ML [mortgagee letter]. If the property does not sell, mortgagors are encouraged to use the deed-in-lieu of foreclosure (DIL) option, providing the title on the property is marketable. By following procedures and time frames included in this ML, a mortgagee may submit a FHA insurance claim and be compensated for the difference between the sales proceeds and the amount owed on the mortgage (including accrued interest and reimbursable costs).

A PFS sale must be an outright sale of the property. If a foreclosure occurs after the mortgagor unsuccessfully participated in the PFS process in good faith, neither the mortgagee nor HUD will pursue the mortgagor for a deficiency judgment.

E. Property Value

Properties offered for sale through the PFS Program are to be listed at no less than the "As Is" value as determined by an appraisal completed in accordance with the requirements of HUD Handbook 4150.2 (Valuation Analysis for Single Family One-to Four-Unit Dwellings). To this end, mortgagees must:

- Obtain a standard electronically-formatted appraisal from an appraiser on FHA's Appraiser Roster. The selected appraiser must not share any business interest with the mortgagor or the mortgagor's agent. Appraisals obtained by the buyer, seller, real estate agent, or other interested parties may not be used to establish the FMV of the property for the PFS Program. It also important to note that:

    1. The appraisal must contain an "as-is" FMV for the subject property;
    2. The appraisal will be valid for six months; and
    3. Distress sales may not be used by the appraiser to establish comparable values unless they represent the only comparables within reasonable proximity of the subject property.

  - Provide a copy of the appraisal to the homeowner, sales agent, or HUD, upon request.

  - Mortgagees are reminded that in accordance with HUD regulations at 24 CFR [Code of Federal Regulations] Part § 203.365 (c) they are responsible for the accuracy of all documentation used in the PFS decision, including accurate and complete appraisal information.

In an effort to ensure that the most current FMV is used for the PFS, a mortgagee may obtain a new FHA appraisal, even if the property was appraised by an FHA Roster Appraiser within the preceding 6 months. To be reimbursed through HUD's claim filing process, the cost of the appraisal must be reasonable and customary for the market area where the appraisal is performed. The appraisal must be retained in the claim/servicing file, even if the PFS is not approved or completed.

H. Approval to Participate

After determining that a mortgagor and property meet the participation requirements herein, the mortgagee must notify the mortgagor using Form HUD-90045 (*Approval to Participate).* The form shall include the date by which the mortgagor's sales contract must be executed.

J. Contract Approval

The mortgagee must determine if the property was marketed at the gross offering price (close to FMV) and the minimum net sales proceeds' requirements (described herein) have been met. The mortgagee will be liable for any insurance claim overpayment on a PFS transaction that closes with net sales proceeds less than the percentages indicated below.

- Net Sales proceeds – Regardless of the property's sale price, a mortgagee may not approve a PFS contract if the net sales proceeds fall below the minimum allowable thresholds stated herein. HUD has established guidelines for varying minimum net sales proceeds based on the length of time a property has been competitively marketed for sale.

    1. For the first 30 days of marketing, mortgagees may only approve offers that will result in minimum net sales proceeds of 88% of the "as-is" appraised FMV.

2. During the next 30 days of marketing, mortgagees may only approve offers that will result in minimum net sales proceeds of 86% of the "as-is" appraised FMV.

3. For the duration of the PFS marketing period, mortgagees may only approve offers that will result in minimum net sales proceeds of 84% of the "as-is" appraised FMV.

4. Mortgagees have the discretion to deny or delay sales where an offer may meet or exceed the 84%, if it is presumed that continued marketing would likely produce a higher sale amount. However, the mortgagee is still limited to 4 to 6 months after the date of the mortgagor's approval to participate in the PFS Program.

- Allowable Settlement Costs – The term "Net Sales proceeds" is defined as the sales price minus closing/settlement costs (i.e., reasonable and customary costs per jurisdiction that are deducted at settlement). Allowable settlement costs include:

  1. Sales commission consistent with the prevailing rate but, not to exceed 6%;

  2. Real estate taxes prorated to the date of closing;

  3. Local/state transfer tax stamps and other closing costs customarily paid by the seller including the seller's costs for a title search and owner's title insurance;

  4. Consideration payable to seller of $750 or $1,000 (i.e., if such consideration is not used to discharge junior liens);

  5. Up to $2,500 to be used for the discharge of junior liens if closing occurs within 90 days. Within 90 days, the first $1,000 represents the mortgagor's consideration and the additional $1,500 represents FHA's consideration for a total of $2,500. If settlement occurs after 90 days, the first $750 represents the mortgagor's consideration and the additional $1,500 represents FHA's consideration for a total of $2,250;

  6. Outstanding partial claim amount. This entire amount must be paid when calculating the net sales proceeds. The seller, buyer, or other interested party may contribute the difference if the net sales proceeds' amount falls below the allowable threshold; and

  7. Up to 1% of the buyer's first mortgage amount if the sale includes FHA financing.