U.S. Department of Housing and Urban Development, Office of Single Family Housing – Washington, DC

Section 203(k) Rehabilitation Loan Mortgage Insurance Program

Office of Audit, Region 5
Chicago, IL

Audit Report Number: 2015-CH-0001
July 31, 2015

To: Kathleen Zadareky, Deputy Assistant Secretary for Single Family Housing, HU

//signed//

From: Kelly Anderson, Regional Inspector General for Audit, 5AGA

Subject: HUD Did Not Always Provide Adequate Oversight of Its Section 203(k) Rehabilitation Loan Mortgage Insurance Program

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 its Section 203(k) Rehabilitation Loan Mortgage Insurance program.

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 8M, 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 312-353-7832.

Audit Report Number: 2015-CH-0001
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HUD Did Not Always Provide Adequate Oversight of Its Section 203(k) Rehabilitation Loan Mortgage Insurance Program

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) oversight of its Section 203(k) Rehabilitation Loan Mortgage Insurance program as part of the activities in our fiscal year 2014 annual audit plan. Our audit objective was to determine whether HUD had adequate oversight of its Section 203(k) program.

What We Found

HUD needs to improve its monitoring of lenders for compliance with the Section 203(k) program requirements because lenders did not always ensure that (1) borrowers or contractors obtained required building permits to rehabilitate properties and (2) contractors were licensed or certified to perform rehabilitation work. In addition, lenders did not always ensure that contractors' cost estimates contained clear descriptions of the proposed repairs to determine eligibility for the Streamlined (k) program. As a result, HUD lacked assurance of the soundness of the repairs, thus potentially impacting the safety of the borrowers and increasing the risk to the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund by more than $1.2 million.

Further, HUD did not always ensure that (1) loan-to-value ratios were correctly calculated when determining borrowers' monthly mortgage insurance premiums and (2) lenders properly entered borrowers' loan information into FHA Connection. As a result, HUD lacked assurance that it (1) properly managed the risk to FHA's Mutual Mortgage Insurance Fund and (2) protected the interests of borrowers due to the overpayment of mortgage insurance. We estimate that nearly 28,000 borrowers had overpaid their premiums by more than $3.2 million as of December 31, 2014, and will continue to overpay their premiums by more than $1.9 million over the next year.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require lenders to (1) support or indemnify HUD for any future losses on the 40 loans with estimated losses totaling more than $1.2 million and (2) support or reimburse HUD for the actual losses incurred on two loans totaling $83,322. We also recommend that HUD (1) strengthen its controls over Section 203(k) program requirements, (2) adjust the formula for calculating the loan-to-value ratio, (3) determine the overpaid mortgage insurance premiums for loans with incorrect loan-to-value ratios, and (4) credit the accounts of active borrowers who overpaid their mortgage insurance premiums and refund overpaid premiums to borrowers for terminated loans.

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Background and Objective

The Federal Housing Administration (FHA) provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. It insures mortgages on single-family and multifamily homes, including manufactured homes and hospitals. FHA is the largest insurer of mortgages in the world, having insured more than 34 million properties since its inception in 1934. Mortgage insurance provides lenders protection against losses as a result of homeowners defaulting on their loans. The lenders bear less risk because FHA will pay a claim to the lender if a homeowner defaults. Loans must meet established requirements to qualify for insurance.

Congress established the Section 203(k) Rehabilitation Loan Mortgage Insurance program in 1978. It is the U.S. Department of Housing and Urban Development's (HUD) primary program for the rehabilitation and repair of single-family properties. The program is an important tool for community and neighborhood revitalization and expanding home-ownership opportunities because it allows the purchase or refinance of a single-family property and the cost for repairs and nonluxury improvements to be included in the loan amount.

A 203(k) loan may be used to rehabilitate an existing one- to four-unit dwelling by (1) purchasing a structure and the land on which the structure is located and rehabilitating it; (2) purchasing a structure on another site, moving it onto a new foundation on the mortgaged property, and rehabilitating it; (3) refinancing the existing indebtedness and rehabilitating such a structure; or (4) rehabilitating such a structure.

HUD offers two Section 203(k) Rehabilitation Loan Mortgage Insurance programs, the Standard (k) and Streamlined (k). The Streamlined (k) program is used for property repairs or improvements that cost $35,000 or less. The Standard (k) program is used for properties that require extensive repairs, including major additions and structural changes.

Under both programs, borrowers are required to obtain all licenses and permits required by local governmental authorities. Funds from borrowers' escrow accounts cannot be released until the local HUD field office or direct endorsement underwriter is assured that these requirements have been satisfied and the fees have been paid. For the Streamlined (k) program, HUD requires lenders to ensure that contractors meet licensing requirements, and the repairs and improvements must comply with any local codes and ordinances. The borrower or contractor must obtain all required permits before starting the work.

In accordance with its requirements, FHA establishes and collects a single premium payment (upfront mortgage insurance premium) and annual mortgage insurance premium based on the loan-to-value ratio of a loan. The annual mortgage insurance premium is determined by calculating the loan-to-value ratio, which is the mortgage insurance amount (excluding the upfront mortgage insurance premium) divided by the appraised value. If the loan-to-value ratio is less than 90 percent, FHA will collect monthly premiums for the first 11 years of the mortgage

term. If the loan-to-value ratio is greater than or equal to 90 percent, FHA will collect monthly premiums for the lesser of the mortgage term or the first 30 years of the mortgage term. However, for loans closed on or after January 1, 2001, with terms of more than 15 years, FHA's annual premium is automatically canceled when the loan-to-value ratio reaches 78 percent, provided that the borrower paid the annual premium for at least 5 years.

HUD's Office of Single Family Housing is responsible for the overall management and administration of the FHA single-family mortgage insurance programs and provides guidance for and oversight of the lenders that participate in its mortgage insurance programs. Its oversight authorities include HUD's Homeownership Centers, which are located in Philadelphia, PA, Denver, CO, Santa Ana, CA, and Atlanta, GA. Within the Homeownership Centers are the Processing and Underwriting and the Quality Assurance Divisions.

The Processing and Underwriting Division performs postendorsement technical reviews on selected FHA-insured loans to evaluate the risk that loans represent to FHA's insurance funds and lenders' compliance with FHA's requirements. The Quality Assurance Division engages in routine and continual monitoring of FHA-approved lenders to identify errors and noncompliance and mitigate risks to the FHA insurance funds. The Division targets lenders for review using a centralized and coordinated targeting methodology, which adapts to changes in business practices and market conditions.

Our objective was to determine whether HUD had adequate oversight of its Section 203(k) program. Specifically, we wanted to determine whether HUD ensured that (1) lenders endorsed loans that complied with program requirements and (2) loan-to-value ratios were properly calculated when determining borrowers' monthly mortgage insurance premiums.

Results of Audit

Finding 1: HUD Needs to Improve Its Monitoring of Lenders For Compliance With the Section 203(k) Program Requirements

HUD needs to improve its monitoring of lenders for compliance with the Section 203(k) program requirements because lenders did not always ensure that (1) borrowers or contractors obtained building permits to rehabilitate properties and (2) contractors were licensed or certified to perform rehabilitation work. Lenders also did not ensure that contractors' cost estimates contained clear descriptions of the proposed repairs to determine eligibility for the Streamlined (k) program. These weaknesses occurred because HUD lacked adequate procedures and controls to ensure that lenders complied with its requirements. As a result, HUD lacked assurance of the soundness of the repairs, thus potentially impacting the safety of borrowers and increasing the risk to FHA's Mutual Mortgage Insurance Fund by more than $1.2 million.

FHA Insured Section 203(k) Loans That Did Not Always Comply With Program Requirements

Using HUD's Single Family Data Warehouse,[1] we identified 70,196 loans insured under HUD's Section 203(k) program that closed from December 1, 2008, through July 31, 2013. We reviewed 106 of the 70,196 loans totaling more than $16 million for compliance with the program's requirements.

Of the 106 loans reviewed, 37 (35 percent) did not comply with the program's requirements. Specifically, FHA insured loans without support that (1) borrowers or contractors obtained building permits required by local government authorities to rehabilitate properties and (2) contractors were specialty licensed[2] or certified to perform rehabilitation work that involved plumbing, mechanical, or electrical repairs or the disturbance of painted surfaces.[3] Additionally, for HUD's Streamlined (k) program, lenders did not always require contractors to provide clear descriptions of the proposed work[4] to ensure that (1) the work would not involve structural repairs and (2) all required repairs were included.[5] The table below shows the deficiencies for the 37 loans.[6]

[1] Single Family Data Warehouse is a large, extensive collection of database tables organized and dedicated to support the analysis, verification, and publication of the Office of Single Family Housing's data.
[2] HUD Handbook 4240.4, REV-2, section 4-9 and appendix 2, and Mortgagee Letter 2005-50. See appendix C for details on related criteria.
[3] As of April 2010, the Environmental Protection Agency requires that contractors that renovate, repair, or prepare surfaces for painting in properties built before 1978 be certified. HUD included this requirement in its Frequently Asked Questions' Valuation Protocol in January 2013.
[4] Mortgagee Letter 2005-50
[5] If structural work was involved, loans would not be eligible under the Streamlined (k) program.
[6] Fifteen of the thirty-seven loans contained two deficiencies.

Type of deficiencies	Count
Lacked support that building permits were obtained before the repairs started	32
Lacked support that contractors had a specialty license or lead-based paint certification	17
Lacked clear descriptions to determine whether the proposed repairs were structural or nonstructural	2
Lacked support that required repairs were completed	1
Total	**52**

The table in appendix D of this report shows the loans with the deficiencies cited above. Additionally, appendix C contains the related criteria.

HUD Reviewed Its 203(k) Loans

Using HUD's Single Family Data Warehouse system and data provided by HUD's Quality Assurance Division, we determined that HUD reviewed 2,453 loans insured under its Section 203(k) program during the period January 1, 2011, through December 31, 2012. We reviewed 86 of the 2,453 loans to determine whether HUD adequately identified and mitigated lenders' noncompliance with the program's requirements.

HUD did not always identify lenders' noncompliance with the program's requirements. Specifically, of the 86 loans reviewed, 18[7] (21 percent) contained deficiencies that were not identified by HUD.

- For 12 loans, there was no evidence that borrowers or contractors obtained required building permits in accordance with local building codes.
- For six loans, there was no evidence that contractors were licensed or certified to perform rehabilitation work that involved plumbing, mechanical, or electrical repairs or the disturbance of painted surfaces.
- For five loans, the contractors' cost estimates did not provide clear descriptions to determine whether the repairs involved structural or nonstructural rehabilitation work.[8]
- For two loans, the repairs were conditioned on the direct endorsement underwriter form HUD 54114, or appraisal report was not sufficiently addressed by the contractors.
- For one loan, the cost estimate did not contain a breakdown of the costs for labor and materials to ensure that the borrower was not reimbursed for labor.

The table in appendix E of this report shows the loans with the deficiencies cited above. Additionally, appendix C contains the related criteria.

[7] Seven of the eighteen loans contained more than one deficiency.

[8] A total of seven loans (2 from the Section 203 (k) loan review + 5 from HUD's review of Section 203(k) loans) lacked clear descriptions to determine whether the repairs were structural or nonstructural.

HUD Lacked Adequate Procedures and Controls

HUD relied on the lenders to ensure that borrowers complied with the Section 203(k) program requirements. For instance, borrowers were expected to determine the soundness of the property before and after rehabilitation, including the value, cost estimates, and ability of the contractor to complete the rehabilitation in a satisfactory, workmanlike manner in compliance with all accepted exhibits and local codes and ordinances as outlined in the Section 203(k) borrower's acknowledgment form. According to HUD, although the program had requirements for the borrowers, lenders had the overall responsibility to ensure that borrowers or contractors obtained all permits. However, several lenders relied on the contractor or borrower to obtain the necessary permits or licenses and did not verify these permits or licenses with the responsible party or the local government authority.

HUD also did not always perform adequate monitoring and oversight of lenders' compliance with program requirements. According to HUD, it lacked the resources to contact the many local governments in the United States to review their guidelines and obtain required documentation since there was no central repository. Therefore, during a postendorsement technical review, a HUD reviewer would review only the documentation that the lender was required to maintain in the FHA case binder, which did not include evidence of building permits and contractor licensing. However, according to HUD, the number of loans insured under its Section 203(k) program was small compared to the number of loans insured under the Section 203(b) program. Therefore, its reviewers may have reviewed only one or two 203(k) loans per week, if any. Specifically, a HUD reviewer stated that the 203(k) loans usually made up only 1 percent of the number of loans reviewed during a postendorsement technical review. For instance, for every 10 loan files reviewed, only 1 may have been for a 203(k) loan. Therefore, it would be unlikely that a HUD reviewer would have to contact many local jurisdictions when reviewing a 203(k) loan as part of a postendorsement technical review.

In June 2013, HUD developed a standardized supplemental review checklist to assist reviewers with reviewing loans insured under the Section 203(k) program. Both HUD's Standard (k) and Streamlined (k) programs require contractors to be licensed and obtain building permits as applicable.[9] However, the supplemental review checklist did not include a review for permits under the Streamlined (k) program. Further, HUD's Post Endorsement Technical Review Desk Guide did not address how the checklist would be used to determine whether the loan was deficient or unacceptable.

Additionally, according to the Director of HUD's Single Family Home Mortgage Insurance Division, HUD had not formally adopted the Environmental Protection Agency's renovation, repair, and painting rule for properties that were not HUD's real estate-owned or federally owned and targeted housing that receives Federal assistance. It also had not issued guidance regarding lead-based paint remediation requirements for non-real estate-owned single-family properties. However, in January 2013, HUD included this requirement in its Frequently Asked Questions' Valuation Protocol. Therefore, it had guidance requiring lenders to comply with the Environmental Protection Agency's requirement.

[9] HUD Handbook 4240.4, REV-2, section 4-9 and appendix 2, and Mortgagee Letter 2005-50 - See appendix C for related criteria.

Further, contractors' cost estimates were not always clear to sufficiently determine whether the loan was eligible for the Streamlined (k) program. According to the Director of HUD's Home Mortgage Insurance Division, lenders should determine whether the repairs would be structural. However, HUD did not require lenders to support their determination that the work would not involve structural repairs. For instance, for FHA case number 137-5861827, the contractor's cost estimate included the demolition of walls in two bedrooms, the dining room, the attic, the kitchen, and the bathroom. However, the cost estimate did not specify whether any of the repairs were for load-bearing structural walls. Further, the lender's loan file did not contain documentation to support how the lender determined that the demolition of the walls was eligible under the Streamlined (k) program.

Conclusion

HUD lacked adequate procedures and controls to ensure that lenders complied with its requirements. As a result of these deficiencies, HUD lacked assurance regarding the soundness of the repairs, thus potentially impacting the safety of the borrowers and increasing the risk to FHA's Mutual Mortgage Insurance Fund by more than $1.2 million for 40 active loans.[10]

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require the lenders to

1A. Support that the repairs to the properties associated with the 32 loans without evidence of permits complied with local code or reimburse HUD $792,837 for the escrow repair funds.

1B. Support that the repairs to the properties associated with the six loans were not structural repairs[11] or indemnify HUD for the four active loans with a total estimated loss of $222,073[12] and reimburse HUD for the actual loss of $83,322 incurred on the sale of two properties associated with FHA case numbers 052-4308836 and 034-8239100.

[10] Of the 55 deficient loans cited in the finding (37 + 18), 46 were active, 7 had been paid in full, and HUD paid claims on the remaining 2 loans according to HUD's Single Family Data Warehouse as of January 1, 2015. Of the 46 active loans, we did not question the cost for 4 loans. For these loans, even though there was no evidence that the contractors were licensed or required permits were obtained ***after*** the repairs were completed, the properties passed their building inspections. Further, we did not question the costs associated with two loans that were cited only for potentially lead-based paint issues because the loans closed before HUD included the Environmental Protection Agency's requirement in its Frequently Asked Questions in January 2013. Therefore, only 40 (55 – 7 – 2 – 4 – 2) active loans were cited for questioned costs in this finding. See appendix F.

[11] A total of seven loans were cited in this finding for unclear cost estimates concerning whether repairs involved structural or nonstructural rehabilitation work (see appendixes D and E). Six of the seven loans were reported in recommendation 1B, and the remaining loan was reported in recommendation 1D.

[12] This amount was based on the loss severity rate of 50 percent of the total unpaid principal balances of $444,145 for the four loans as of January 29, 2015.

1C. Support that the borrower for FHA case number 451-1165810 was not reimbursed for the cost of labor or indemnify the loan with an estimated loss amount of $83,715, based on the loss severity rate of 50 percent of the unpaid principal balance of $167,429 as of January 29, 2015.

1D. Support that the repair conditions and comments indicated in the direct endorsement underwriter form, form HUD-54114, were satisfied for FHA case number 501-8198149. If the repair conditions and comments were not properly addressed, the lenders should indemnify the loan with an estimated loss amount of $39,367, based on the loss severity rate of 50 percent of the unpaid principal balance of $78,733 as of January 29, 2015.

1E. Support that the required repairs to the property associated with FHA case numbers 241-9513470 and 277-1438986 were sufficiently addressed and complied with local codes or indemnify HUD for the estimated loss of $97,355, based on the loss severity rate of 50 percent of the unpaid balance of $194,709 as of January 29, 2015.

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

1F. Revise HUD's policies and procedures, including the supplemental 203(k) review checklist and review rating guidelines, to ensure that HUD reviewers properly and consistently identify and resolve deficiencies.

1G. Ensure that postendorsement technical reviewers receive sufficient training to understand the scope of the repairs and improvements by contractors.

1H. Provide clarification to lenders regarding their responsibility to ensure that (1) repairs or improvements comply with local building codes, (2) contractors that perform specialized work are appropriately licensed, and (3) contractors provide clear descriptions of the work to be performed to sufficiently determine whether the repairs or improvements are structural.

1I. Revise its existing policies governing the 203 (k) program or implement a new policy requiring lenders to review the scope of the repairs or renovations and determine whether (1) building permits are required for the work and (2) contractors meet jurisdictional licensing and bonding requirements. The policy should also require lenders to maintain documentation supporting their review and determination.

1J. Develop and implement a complete training program for lenders that participate in the 203(k) programs. The training program should include but not be limited to ensuring the lenders understand their responsibilities to communicate FHA's 203(k) requirements to their client borrowers and contractors concerning

contractor licensing and building permits as required by local government authorities.

1K. Communicate with HUD reviewers and lenders about HUD's inclusion of the Environmental Protection Agency's renovation, repair, and painting (lead safe) rule in HUD's Valuation Protocol Frequently Asked Questions.

Finding 2: HUD Did Not Always Ensure That Loan-to-Value Ratios Were Properly Calculated When Determining Borrowers' Mortgage Insurance Premiums

HUD did not always ensure that (1) loan-to-value ratios were correctly calculated when determining borrowers' monthly mortgage insurance premiums and (2) lenders properly entered borrowers' loan information into FHA Connection.[13] These weaknesses occurred because HUD lacked adequate procedures and controls to ensure that (1) the formula for calculating the loan-to-value ratio in its Computerized Homes Underwriting Management System[14] was accurate and (2) it provided lenders with complete and accurate information and adequately monitored lenders to ensure that they entered accurate data into FHA Connection. As a result, HUD lacked assurance that it (1) properly managed the risk to FHA's Mutual Mortgage Insurance Fund and (2) protected the interests of borrowers due to the overpayment of mortgage insurance. We estimated that nearly 28,000 borrowers had overpaid their premiums by more than $3.2 million as of December 31, 2014, and will continue to overpay their premiums by more than $1.9 million over the next year.

HUD's System Did Not Properly Calculate Borrowers' Mortgage Insurance Premiums

Using HUD's Single Family Data Warehouse, we identified 70,196 loans insured under HUD's Section 203(k) program that closed from December 1, 2008, through July 31, 2013. We selected 150 loans totaling more than $22 million to determine the accuracy of borrowers' mortgage insurance premiums.

HUD did not ensure that the formula in its Computerized Homes Underwriting Management System correctly calculated loan-to-value ratios[15] when determining borrowers' mortgage insurance premiums. Specifically, the loan-to-value ratios for 92 (61 percent) of the 150 loans reviewed were either overcalculated or undercalculated.

- The loan-to-value ratios were overcalculated for 80 loans; thus, the borrowers would pay the monthly premiums for a longer period over the life of their loans. Further, borrowers for 61 of the 80 loans had overpaid their monthly insurance premiums by $12,576 as of September 30, 2014, and will continue to overpay.[16] Although the borrowers for the remaining 19 loans had not overpaid their monthly premiums, they will pay their insurance premiums for additional months due to the overcalculated loan-to-value ratios.

[13] FHA Connection is an Internet-based system that allows FHA-approved lenders to have real-time access to several of FHA's systems over HUD's Internet system for the purpose of originating and servicing FHA loans.
[14] The Computerized Homes Underwriting Management System automates the single-family mortgage insurance application process.
[15] HUD's Computerized Homes Underwriting Management System manual, dated November 2011. See appendix C for details on related criteria.
[16] Borrowers will continue to overpay or underpay their premiums for at least 5 years and until their loan-to-value ratio reaches 78 percent or the loan is no longer insured by HUD.

- The loan-to-value ratios were undercalculated for 12 loans; thus, the borrowers would pay the monthly premiums for a shorter period over the life of their loans. Further, borrowers for 2 of the 12 loans had underpaid their premiums by $158 as of September 30, 2014, and will continue to underpay. Although the borrowers for the remaining 10 loans had not underpaid their monthly premiums, they will pay their insurance premiums for fewer months due to the undercalculated loan-to-value ratios.

We estimated that nearly 28,000 borrowers had overpaid their premiums by more than $3.2 million as of December 31, 2014, and will overpay their premiums by more than $1.9 million over the next year.[17]

The tables in appendixes G and H of this report represent the loans with the deficiencies cited above.

Lenders Did Not Properly Enter Loan Data Into FHA Connection for the Computation of Loan-to-Value Ratios

HUD did not always ensure that lenders correctly and consistently entered loan data into FHA Connection. Of the 92 loans with inaccurate loan-to-value ratios, for 65 loans,[18] lenders incorrectly entered (1) property appraised values for 37 loans, (2) contract sale prices for 15 loans, or (3) repair escrow amounts for 31 loans.[19]

HUD Lacked Adequate Procedures and Controls

HUD lacked adequate procedures and controls to ensure that its formula for calculating the loan-to-value ratio in its System was accurate. To calculate the ratio, a lender would enter a property's appraised value into HUD's System. The System would then use the value to calculate the (1) maximum mortgage amount and (2) loan-to-value ratio for determining the borrower's premium. According to the System's manual, for loans that involve the purchase of a property that was endorsed on or after November 12, 2008, to calculate the loan-to-value ratio, the System would use the original mortgage amount without the upfront premium divided by the lesser of (1) the appraised value or (2) the sale price plus the repair escrow amount.[20] However, according to HUD, to determine the loan-to-value ratio for calculating borrowers' premiums, the System should divide only the original mortgage amount without the upfront premium by the appraised value.[21]

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[17] See Scope and Methodology.

[18] Fourteen loans contained more than one deficiency. See appendixes G and H.

[19] The property appraised value, contract sale price, and repair escrow amount data fields were needed to compute borrowers' mortgage insurance premiums in HUD's System.

[20] For Section 203(k) loans that were refinanced and closed from November 13, 2008, through September 21, 2009, the formula for calculating the loan-to-value ratio was the mortgage without the upfront premium divided by the unpaid principal balance plus any escrow funds. For Section 203(k) loans that were refinanced after September 21, 2009, the formula is the mortgage amount without the upfront premium divided by the appraised value.

[21] We obtained a legal opinion from the Office of Inspector General's Office of Legal Counsel regarding the definition of appraised value for determining borrowers' monthly mortgage insurance premium. Counsel opined that the appraised value is the after-improved value of the property. See appendix C for details.

In addition, HUD did not always provide lenders with complete and accurate information. In May 2012, HUD posted instructions on FHA Connection's message board requesting that lenders enter the lesser of the total sale price plus the repair escrow amount or 110 percent of the after-improved value from the maximum mortgage calculation worksheet, form HUD-92700, into the appraised value field in FHA Connection to calculate the loan-to-value ratio. These instructions resulted in some lenders contacting HUD's homeownership centers seeking additional clarification or guidance. However, the clarification or guidance that the lenders received was not consistent. Specifically, a lender disagreed with HUD's posted instructions regarding the data that should be entered into FHA Connection as a property's appraised value because (1) the lesser of the total sale price plus the repair amount or 110 percent of the after-improved value would result in the loan-to-value ratio ***always*** being 96.5 percent for all loans and (2) repairs to rehabilitate properties do not always result in a dollar-for-dollar return. Therefore, using this approach to determine the value of the property was not accurate.

In 2012, HUD created a working group to consolidate all FHA mortgagee letters and update its handbook. In addition, the group worked on resolving the inconsistencies regarding the calculation of the loan-to-value ratio. However, until these changes are fully implemented and communicated to the lenders, the process for underwriting, regarding the computation of the loan-to-value ratio for borrowers' mortgage insurance premiums, will not be consistent among lenders participating in the Section 203(k) program.

Conclusion

The deficiencies described above occurred because HUD lacked adequate procedures and controls to ensure that (1) the formula for calculating the loan-to-value ratio in its System was accurate and (2) it provided lenders with complete and accurate information and adequately monitored lenders to ensure that they entered accurate data into FHA Connection. As a result, HUD lacked assurance that it (1) properly managed the risk to FHA's Mutual Mortgage Insurance Fund and (2) protected the interests of borrowers due to the overpayment of mortgage insurance. We estimated that nearly 28,000 borrowers had overpaid their premiums by more than $3.2 million as of December 31, 2014, and will continue to overpay their premiums by more than $1.9 million over the next year.

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing

2A. Reimburse or apply $10,552 in credit to borrowers' future premiums for the 54 active loans[22] with overpaid premiums and refund $2,024 to the borrowers of the 7 terminated loans.

[22] Of the 61 loans cited for overpayment of mortgage insurance premiums, 54 were active in HUD's Single Family Data Warehouse as of January 1, 2015. The remaining seven loans had been terminated. The total premium overpayment for the seven terminated loans was $2,024. Thus, the total amount of the overpaid premiums for the remaining 54 active loans was $10,552 ($12,576 – $2,024), as calculated through September 2014.

2B. Determine the overpaid mortgage insurance premium for the 69 active loans[23] after September 2014 for the life of the loans, and reimburse or apply the overpayments as credits to borrowers' future premium payments.

2C. Determine the number of 203(k) loans[24] impacted by the incorrect loan-to-value ratio for mortgage insurance premium calculations and when applicable, reimburse borrowers or apply the overpaid premiums as credits toward borrowers' future premium payments.

2D. Issue clarification to lenders regarding the property value that should be used to calculate loan-to-value ratios for determining borrowers' premiums, which is different from the value used to determine the maximum mortgage amount under the program.

2E. Change the loan-to-value ratio calculation in HUD's System to reflect the issued clarification in recommendation 2D. This correction to the loan-to-value ratio calculation should result in $1.91 million in funds to be put to better use.

2F. Update the FHA Connection user manual by providing clear descriptions of and instructions for the data fields to ensure that lenders understand and enter the correct loan data into FHA Connection for computing borrowers' premiums.

[23] Eighty loans with overcalculated loan-to-value ratios less 11 terminated loans. See appendix G.
[24] Excluding the 150 loans reviewed during the audit.

Scope and Methodology

We performed our audit work from February 2013 through October 2014 at our offices located in Chicago, IL, Columbus, OH, and Detroit, MI. The audit covered the period December 1, 2008, through July 31, 2013.[25] To accomplish our objective, we

- Reviewed relevant background information and applicable HUD handbooks, mortgagee letters, the Code of Federal Regulations, the United States Code, FHA's Post Endorsement Technical Review Desk Guide (effective October 2010), the Quality Assurance Division Desk Guide, the Computerized Homes Underwriting Management System manual (effective November 2011), the FHA Connection message board, and HUD's Web site.
- Communicated with HUD staff, lenders, consultants, and local government authorities as applicable.
- Reviewed applicable documentation in the loan files, including but not limited to the maximum mortgage worksheet, rehabilitation agreement, 203(k) borrower's acknowledgement, homeowner-contractor agreement, and borrower's identity-of-interest certification as well as the contractors' licensing, building permits, cost estimates, draw requests, appraisal reports, and settlement statements.
- Downloaded and analyzed loan-level data from HUD's Single Family Data Warehouse.
- Reviewed loan-level data from HUD's Neighborhood Watch Early Warning System.[26]
- Selected and reviewed statistical and random samples of loans related to the 203(k) program.
- Reviewed Accurint[27] information for the selected loans.

Statistical Samples

Lender Compliance With Section 203(k) Program Requirements

For the survey, using HUD's Single Family Data Warehouse system, we identified 552 loans that closed between January 1, 2011, and December 31, 2012, and the borrowers of which defaulted in their mortgage payments within the first 12 months as of January 2013. Using the U.S. Army Audit Agency Statistical Sampling System software, we selected a statistical random sample of 41 loans, using a 90 percent confidence level with an expected error rate of 20 percent and a

[25] Initially, our audit period covered January 1, 2011, through December 31, 2012. However, due to the change in the loan-to-value ratio calculation formula for loans with FHA case numbers assigned on and after November 13, 2008, we adjusted our audit period to include 203(k) loans that closed between December 1, 2008, and July 31, 2013, for our loan-to-value ratio calculation testing.

[26] Neighborhood Watch is a Web-based software application that displays loan performance data for lenders using FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.

[27] The Accurint database is an online resource that provides information on legal and public records.

sampling precision of 10 percent. We reviewed the first 11 loans to determine whether an audit was warranted.

Based on the results and the survey, we expanded our testing universe to include all loans that closed during our audit scope. Using HUD's Single Family Data Warehouse system, we identified 70,196 203(k) loans, valued at more than $10.7 billion that were closed between December 1, 2008, and July 31, 2013. We selected a statistical sample of 95 across 6 cost strata. To control for accuracy, we excluded loans with mortgage terms of less than 15 years and 775 loans that exceeded $540,000 in value[28] before we arrived at this total. Therefore, we reviewed 106 (11 + 95) loans to determine whether lenders endorsed loans that complied with HUD's 203(k) requirements, in particular contractor licensing, building permits, and the eligibility of the work items under the Standard (k) and Streamlined (k) programs.[29]

HUD's Review of Section 203(k) Loans

Using HUD's Single Family Data Warehouse system, we determined that HUD's Processing and Underwriting Division reviewed 2,022 loans[30] insured under HUD's Section 203(k) program that closed from January 1, 2011, through December 31, 2012. Using the U.S. Army Audit Agency Statistical Sampling System software, we randomly selected 69 of the 2,022 postendorsement technical reviews to determine whether (1) lenders complied with HUD's 203(k) requirements and (2) HUD identified material deficiencies and required appropriate corrective actions, when applicable, during its review of the 203(k) loans. Our sampling criteria used a 90 percent confidence level and a sample precision level of 10 percent.

During the survey, we received the listing of 550 loans reviewed by HUD's Quality Assurance Division between January 1, 2011, and December 31, 2012. Of these, we excluded 116 terminated loans from our audit universe because they would not increase the risk to FHA insurance funds. The remaining 434 contained 409 active loans and 25 loans for which FHA had paid a claim. Of the 409 active loans, we statistically selected a sample of 59 loans with an initial survey sample of 14 loans for the file reviews. We reviewed only nine of these selected loans. Additionally, we selected and reviewed the first 8 of the 25 loans for which FHA had paid a claim to determine whether (1) lenders complied with HUD's 203(k) requirements and (2) HUD identified material deficiencies and required appropriate corrective actions, when applicable, during its review of the 203(k) loans. Therefore, we reviewed 86 (69 + 9 + 8) loans to determine whether HUD adequately identified and mitigated lenders' noncompliance with the program's requirements.[31]

[28] We excluded the loans with a mortgage term of less than 15 years and loans that exceeded $540,000 because they represented less than 1 percent of the universe of 203(k) loans; thus, these loans were considered outliers. In statistical sampling, an outlier is an element of a data set that distinctly stands out from the rest of the data.
[29] Since the costs were unsupported, we did not project them to the universe.
[30] These loans exclude 53 203(k) loans that had been either referred to or indemnified by HUD's Quality Assurance Division as of March 7, 2013.
[31] We reviewed only 9 of the 14 active loans and 8 of the 25 loans that had claim insurance status during the survey phase to accomplish our objective (17 loans). During the audit phase, we did not review the remaining 22 sampled loans. The loans reviewed by HUD's Quality Assurance Division represented less than 1 percent of the 203(k) loans

Loan-to-Value and Mortgage Insurance Premium Reviews

Using HUD's Single Family Data Warehouse system, we identified 70,196 203(k) loans that were closed from December 1, 2008, through July 31, 2013, valued at more than $10.7 billion. To control for accuracy, we excluded 613 loans with mortgage terms of less than 15 years, and 775 loans that exceeded $540,000 in value were excluded as outliers before we arrived at this total. We selected a statistical sample of 150 loans to determine whether the loan-to-value ratios were properly calculated for the borrowers' monthly mortgage insurance premiums.

The sample was designed as a highly stratified systematic sample and to control for variance resulting from different sizes of loans as well as the impact different ages of loans would have on the amount of mortgage insurance premium payments incurred by loans. We stratified the sample by 6 cost groups and 6 age divisions within each cost group for a total of 36 strata. The details of these strata are as noted in the sample design table below. The cost groupings were created by ranking loans in order of their unpaid balance and dividing them into six cost tiers by percentile within this ranking. Age groupings were created according to periods when mortgage insurance premium amounts were changed by policy and periods when HUD had issued new guidance to banks on how to enter the information used to compute mortgage insurance premium amounts. The sample design was stratified as shown in the table below.

Sample design					
Stratum name	Cost group		Rehabilitation loans	Sample size	Sampling weights
	Rank	Lower bound			
Tier1_0-6 mos.	0-10pct	0.00	560	2	280.000
Tier1_07-16 mos.			1,228	3	409.333
Tier1_17-28 mos.			1,950	4	487.500
Tier1_29-34 mos.			648	2	324.000
Tier1_35-48 mos.			1,723	4	430.750
Tier1_48+ mos.			987	2	493.500
Tier2_0-6 mos.	10-30pct	67,322	1,283	3	427.667
Tier2_07-16 mos.			3,000	6	500.000
Tier2_17-28 mos.			3,942	8	492.750
Tier2_29-34 mos.			1,253	3	417.667
Tier2_35-48 mos.			3,154	7	450.571
Tier2_48+ mos.			1,558	3	519.333
Tier3_0-6 mos.	30-50pct	97,886	1,541	3	513.667
Tier3_07-16 mos.			3,261	7	465.857
Tier3_17-28 mos.			3,588	8	448.500
Tier3_29-34 mos.			1,315	3	438.333
Tier3_35-48 mos.			3,082	6	513.667

that closed from January 1, 2011, through December 31, 2012. Since the costs were unsupported, we did not project them to the universe.

Sample design					
Stratum name	Cost group		Rehabilitation loans	Sample size	Sampling weights
	Rank	Lower bound			
Tier3_48+ mos.			1,404	3	468.000
Tier4_0-6 mos.	50-70pct	130,602	1,677	3	559.000
Tier4_07-16 mos.			3,363	7	480.429
Tier4_17-28 mos.			3,500	7	500.000
Tier4_29-34 mos.			1,272	3	424.000
Tier4_35-48 mos.			3,092	6	515.333
Tier4_48+ mos.			1,286	3	428.667
Tier5_0-6 mos.	70-90pct	174,202	1,923	4	480.750
Tier5_07-16 mos.			3,622	8	452.750
Tier5_17-28 mos.			3,247	7	463.857
Tier5_29-34 mos.			1,348	3	449.333
Tier5_35-48 mos.			2,944	6	490.667
Tier5_48+ mos.			1,106	2	553.000
Tier6_0-6 mos.	90-100pct	273,100	1,082	2	541.000
Tier6_07-16 mos.			1,695	3	565.000
Tier6_17-28 mos.			1,329	3	443.000
Tier6_29-34 mos.			636	2	318.000
Tier6_35-48 mos.			1,209	2	604.500
Tier6_48+ mos.			388	2	194.000
Totals	**N/A**	**N/A**	**70,196**	**150**	**N/A**

To design a sample that is sensitive enough to detect this kind of error, we needed to reconstruct the types of overpayments and underpayments in mortgage insurance premiums that would likely be found in the audit. Based on a sample of 60 rehabilitation loans that underwent a postendorsement technical review, we found that the primary driver of mortgage insurance premium error was an incorrect calculation of the loan-to-value ratio. The loan-to-value ratio was miscalculated about 72 percent of the time in the postendorsement technical review sample. When the loan-to-value ratio was miscalculated, the error amount ranged from a slight underestimate of 14 percent or more to a larger overestimate of 34 percent or more, and the probability distribution of this error followed a Weibull distribution.

To recreate these typical error amounts, we applied randomly assigned loan-to-value ratio errors that followed the same Weibull distribution and estimated the effect on the mortgage insurance premium. We calculated both the cost of errors in monthly payment amounts and the cost of failing to end the mortgage insurance premium when the true loan-to-value ratio dropped below the level at which it was required. These calculations included monthly estimates of interest, principal, and loan balances during the history of the loan through September 2013.

A sample size of 150, as was recommended for this audit, was randomly selected with the number of samples in each stratum being proportionate to that found in the population, with minor rounding adjustments as needed to specify whole-number sample counts within each stratum. The audit sample survey was selected by means of computer routines written in SAS®,

using the survey select procedure and a seed of 7. We arrived at this number by simulating the performance of various sample designs.

Having established the typical cost impact from a loan-to-value ratio error, we tested the ability of our stratification design to pick up various rates of error and various sample sizes. We did this by means of computerized, replicated sampling to reproduce the true precision and reliability that an audit finding would have with various sample sizes and rates of error. We varied the possible rate of loan-to-value ratio error from 40 to 80 percent (our test sample had an error rate of 72 percent), and sample sizes ranging from 70 to 150 samples were tested. The resulting audit findings from these simulations were compared with actual dollar amounts in a given error scenario to verify how accurate an audit would be using these estimating methods. The recommended sample size was found to be effective in preventing false errors, and the rate of accuracy for probabilistic statements made with this sample design was better than the stated confidence interval.

We found that borrowers for 62 of the 150 rehabilitation loans were billed and paid an incorrect monthly amount for their mortgage insurance premium (either too much or too little). This amounted to a weighted average of 41.7 percent of our sample. In projecting the results of our sample to the universe of 70,196 loans, we can say, with a one-sided confidence interval of 95 percent, that at least 24,762 borrowers, or 35.28 percent of our audit sample, were billed and paid the wrong monthly amount for their premium.

Percentage of loans:	$41.7\% - 1.658 \times 3.87\% \approx 35.28\%_{LCL}$
Count of loans:	$70{,}196 * (41.7\% - 1.658 \times 3.87\%)$[32] $\approx 24{,}762_{LCL}$

Further, the weighted average for the overpaid premiums was $55.96 per rehabilitation loan. In deducting for a statistical margin of error, we can say, with a one-sided confidence interval of 95 percent, that the average amount per rehabilitation loan was $41.55. Projecting this amount to the audit universe of a total of 70,196 rehabilitation loans yields at least $2.9 million in overpaid premiums. Looking forward 1 year, if this behavior continues, the annualized projected amount of overpaid premiums for rehabilitation loans will be $1.7 million in funds to be put to better use.

Sample projection:	$\$55.96 - 1.658 \times \$8.69 \approx \$41.55_{LCL}$
Universe projection:	$\$3{,}927{,}839 - 1.658 \times \$609{,}276 \approx \$2{,}910{,}000_{LCL}$
Monthly projection of overpayments:	$\$2.55 - 1.658 \times \$0.319 \approx \$2.02_{LCL}$
Forward 1 year of overpayments:	$70{,}196 \times 12 \times (\$2.55 - 1.658 \times \$0.319) \approx \$1{,}700{,}000_{LCL}$[33]

We updated our audit universe to include loans that had closed as of December 31, 2014. Therefore, the audit universe contained 79,012 active loans totaling more than $12.1 billion. We found that borrowers for 62 of the 150 rehabilitation loans were billed and paid an incorrect

[32] The percentages were rounded to the nearest hundredths.
[33] This amount was rounded.

monthly amount for their mortgage insurance premium (either too much or too little). This amounts to a weighted average of 41.7 percent of our sample. Projecting the results of our sample to the universe of 79,012 loans, we can say, with a one-sided confidence interval of 95 percent, that at least 27,800 borrowers were billed and paid the wrong monthly amount for their premium, thus yielding more than $3.2 million in overpaid premiums. Looking forward 1 year, if this behavior continues, the annualized projected amount of overpaid premiums for rehabilitation loans will be more than $1.9 million in funds to be put to better use.

Count of loans:	$79{,}012 * (41.7\% - 1.658 \times 3.87\%) \approx 27{,}800_{LCL}$
Universe projection:	$\$4{,}421{,}512 - 1.658 \times \$686{,}614 \approx \$3{,}280{,}000_{LCL}$
Forward 1 year of overpayments	$79{,}012 \times 12 \times (\$2.55 - 1.658 \times \$0.319) \approx \$1{,}910{,}000_{LCL}$

Computation of Borrower's Monthly Mortgage Insurance Premium – Explained

According to HUD's Home Mortgage Insurance Division's working group, the after-improved value shown in the appraisal report should be the denominator used to calculate the loan-to-value ratio for determining a borrower's monthly mortgage insurance premium.[34] Once the loan-to-value ratio is calculated, the annual mortgage premium rate is determined for the mortgage insurance premium computation, depending on the following:

- The loan case assignment date,
- Whether the calculated loan-to-value ratio is (1) 95 percent or less or (2) greater than 95 percent, and
- The type of loan transaction (purchase, full qualifying refinance, streamline refinance).

For instance, for a purchase loan case assigned on or after April 9, 2012,[35] the annual mortgage premium rate would be 1.20 percent if the loan-to-value ratio equaled 95 percent or less; however, the annual mortgage premium rate would be 1.25 percent if the loan-to-value ratio was calculated at greater than 95 percent.

Using the Single Family Servicing mortgage calculator in FHA Connection, we recalculated a borrower's monthly mortgage insurance premium by entering applicable loan data, including the loan amount, after-improved value, interest rate, loan term, beginning amortization month and year, and case assignment date. We also adjusted the annual mortgage premium rate accordingly, based on our calculation of the loan-to-value ratio. Examples of how we calculated the overpayment and underpayment of the mortgage insurance premium are below.

Examples for Overcalculated Loan-to-Value Ratios[36]

For FHA case number 277-1777708, HUD's System and the Office of Inspector General (OIG) calculated the loan-to-value ratio at 96.49 percent and 94.43 percent, respectively. Using the

[34] See footnote 21.
[35] For loans with mortgage terms greater than 15 years. See Mortgagee Letter 2012-04.
[36] See appendix G.

prescribed annual mortgage premium rate in Mortgagee Letter 2012-04, OIG calculated the borrower's monthly mortgage insurance premium as $331.50 instead of $345.31, using HUD's loan-to-value ratio. The borrower's monthly premium calculated by HUD's System was $13.81 ($345.31 – $331.50) more than OIG's amount for the first 12 months[37] and $13.56 more over the next 12 months, resulting in the borrower's overpaying for mortgage insurance from April 2013 through September 2014[38] by $247 ($13.81 x 12 months + $13.56 x 6 months). Additionally, with a 96.49 percent loan-to-value ratio, the borrower would be required to pay monthly premiums for 108 months totaling $34,214. However, using a 94.43 percent loan-to-value ratio, as calculated by OIG, the borrower would pay the monthly premium for only 99 months totaling $30,377. Therefore, using the loan-to-value ratio in HUD's System, the borrower would pay insurance premiums for an additional 9 months and overpay for mortgage insurance by $3,837.[39]

For FHA case number 156-1664066, HUD's System and OIG calculated the loan-to-value ratio at 96.49 percent and 95.93 percent, respectively. Therefore, with both loan-to-value ratios above 95 percent, the same annual mortgage insurance premium rate of 1.25 percent applies, resulting in the same monthly mortgage insurance premium of $84.32. However, based on HUD's incorrectly calculated loan-to-value ratio of 96.49 percent, the borrower would pay premiums for 2 (118 – 116) additional months because it would take longer for the ratio to decrease to the 78 percent threshold.

Undercalculated Loan-to-Value Ratios[40]

For FHA case number 156-1541251, HUD's System and OIG calculated the loan-to-value ratio at 93.64 percent and 103.01 percent, respectively. Therefore, using the prescribed annual mortgage premium rate in Mortgagee Letter 2012-04, OIG calculated the borrower's monthly mortgage insurance premium as $81.93 instead of $78.66, using HUD's loan-to-value ratio. The borrower's monthly premium was $3.27 ($81.93 – $78.66) less than OIG's amount for the first 12 months and $3.22 less for the next 12 months, resulting in the borrower's underpaying for mortgage insurance from January 2013 through September 2014 by $68 ($3.27 x 12 months + $3.22 x 9 months). Further, with a 93.64 percent loan-to-value ratio, the borrower would be required to pay the monthly premiums for 96 months totaling $7,012. However, using the 103.01 percent loan-to-value ratio, as calculated by OIG, the borrower would pay the monthly premium for 131 months totaling $ 9,605. It would also take longer for the ratio to decrease to the 78 percent threshold. Therefore, using the loan-to-value ratio in HUD's System, the borrower would pay the insurance premiums for fewer months (35 months) and underpay for mortgage insurance by $2,593.[41]

For FHA case number 093-6893539, HUD's System and OIG calculated the loan-to-value ratio at 96.49 and 100.34 percent, respectively. Therefore, with both loan-to-value ratios above 95

[37] The monthly premium amount was reduced after each 12 months.
[38] Mortgage insurance premium calculations were as of September 2014.
[39] Borrowers will continue to overpay their premiums for at least 5 years and until their loan-to-value ratio reaches 78 percent or is no longer insured by HUD.
[40] See appendix H.
[41] Borrowers will continue to underpay their premiums for at least 5 years and until their loan-to-value ratio reaches 78 percent or is no longer insured by HUD.

percent, the same annual mortgage insurance premium rate of 0.55 percent applies,[42] resulting in the same monthly mortgage insurance premium of $36.57. However, based on HUD's incorrectly calculated loan-to-value ratio of 96.49 percent, the borrower would pay premiums for 16 (145 – 129) fewer months because it would take less time for the ratio to decrease to the 78 percent threshold.

We relied in part on information maintained in HUD's Neighborhood Watch and Single Family Data Warehouse systems for informational and sampling purposes only. We also relied on data maintained in the lenders' systems, such as electronic loan files. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes. The HUD System data for sampled items were validated by reviewing documents maintained by the lenders. The audit results were based on our review of electronic and supporting hardcopy documentation maintained by the lenders and local government authorities.

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(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

[42] See Mortgagee Letter 2008-22.

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:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

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 lacked adequate procedures and controls to ensure that lenders required borrowers or contractors to obtain building permits to rehabilitate properties. It also did not ensure that

lenders required that (1) contractors be licensed or certified to perform rehabilitation work or (2) contractors' cost estimates contain detailed descriptions of the proposed repairs to determine eligibility for the Streamlined (k) program (see finding 1).

- HUD lacked adequate procedures and controls to ensure that (1) it correctly calculated loan-to-value ratios when determining borrowers' monthly mortgage insurance premiums and (2) lenders properly entered borrowers' loan information into FHA Connection (see finding 2).

Appendixes

Appendix A

Schedule of Questioned Costs and Funds To Be Put to Better Use

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A		$792,837	
1B		305,395	
1C		83,715	
1D		39,367	
1E		$97,355	
2A	$12,576		
2E			$1,910,000
Totals	**$12,576**	**$1,318,669**	**$1,910,000**

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

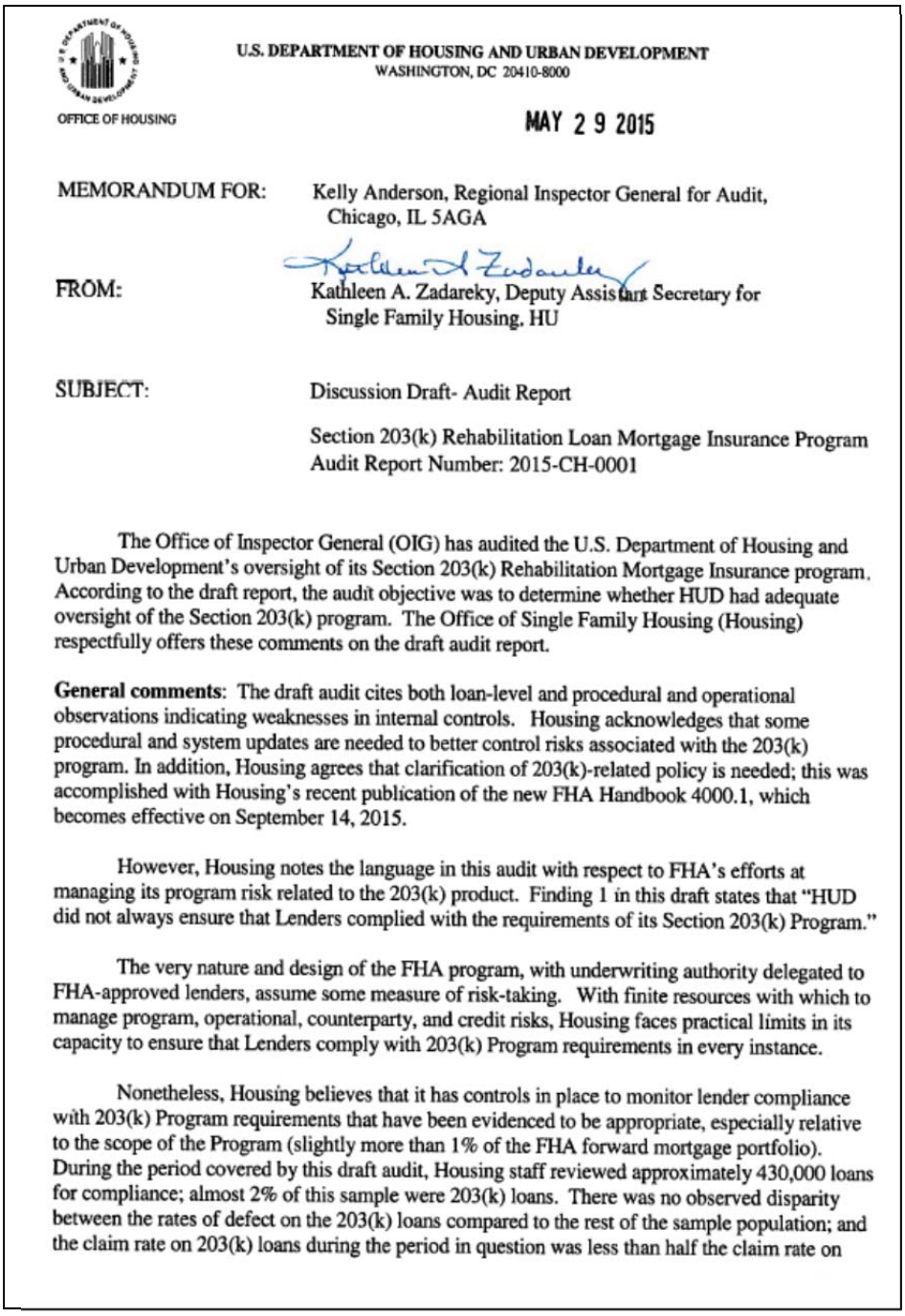
2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ 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. In this case, if HUD implements our recommendation 2E, it will reduce the risk of borrowers overpaying monthly mortgage insurance premiums under the 203(k) program. Our estimate reflects only the initial year of this benefit.

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

MAY 2 9 2015

MEMORANDUM FOR: Kelly Anderson, Regional Inspector General for Audit, Chicago, IL 5AGA

FROM: Kathleen A. Zadareky, Deputy Assistant Secretary for Single Family Housing, HU

SUBJECT: Discussion Draft- Audit Report

Section 203(k) Rehabilitation Loan Mortgage Insurance Program
Audit Report Number: 2015-CH-0001

The Office of Inspector General (OIG) has audited the U.S. Department of Housing and Urban Development's oversight of its Section 203(k) Rehabilitation Mortgage Insurance program. According to the draft report, the audit objective was to determine whether HUD had adequate oversight of the Section 203(k) program. The Office of Single Family Housing (Housing) respectfully offers these comments on the draft audit report.

Comment 1

General comments: The draft audit cites both loan-level and procedural and operational observations indicating weaknesses in internal controls. Housing acknowledges that some procedural and system updates are needed to better control risks associated with the 203(k) program. In addition, Housing agrees that clarification of 203(k)-related policy is needed; this was accomplished with Housing's recent publication of the new FHA Handbook 4000.1, which becomes effective on September 14, 2015.

Comment 2

However, Housing notes the language in this audit with respect to FHA's efforts at managing its program risk related to the 203(k) product. Finding 1 in this draft states that "HUD did not always ensure that Lenders complied with the requirements of its Section 203(k) Program."

The very nature and design of the FHA program, with underwriting authority delegated to FHA-approved lenders, assume some measure of risk-taking. With finite resources with which to manage program, operational, counterparty, and credit risks, Housing faces practical limits in its capacity to ensure that Lenders comply with 203(k) Program requirements in every instance.

Comment 3

Nonetheless, Housing believes that it has controls in place to monitor lender compliance with 203(k) Program requirements that have been evidenced to be appropriate, especially relative to the scope of the Program (slightly more than 1% of the FHA forward mortgage portfolio). During the period covered by this draft audit, Housing staff reviewed approximately 430,000 loans for compliance; almost 2% of this sample were 203(k) loans. There was no observed disparity between the rates of defect on the 203(k) loans compared to the rest of the sample population; and the claim rate on 203(k) loans during the period in question was less than half the claim rate on

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation	Auditee Comments

other forward mortgages.

Comment 4

The draft report also includes some concerns related to building permits and contractor licensing in 203(k) rehabilitation projects. The report cites roughly 40 loans with alleged violations of FHA policy. Single Family Housing notes that almost 85% of the violations were related to permits not being obtained prior to the start of construction.

Comment 5

However, FHA does not require copies of building permits to be included in the endorsement case binder; mere absence of a building permit is not sufficient evidence that the borrower or the borrower's contractor did not obtain such documentation. Furthermore, the requirement to obtain a building permit when necessary is that of the borrower or contractor, not of the FHA-approved lender. In these instances, then, Housing believes that the loans were compliant with FHA requirements.

Specific comments: Housing offers the following comments on specific Recommendations included in the draft audit report.

Specific comment 1: Housing agrees that contractors performing repairs under the 203(k) program should be licensed or certified as required by the local jurisdiction and that contractors should supply clear descriptions of the proposed repairs. HUD offers two Section 203(k) Rehabilitation Loan Mortgage Insurance programs, the Standard (k) and Streamlined (k). The Streamlined (k) program is used for property repairs or improvements that cost $35,000 or less. The Standard (k) program is used for properties that require extensive repairs, including major additions and structural changes.

Under both programs, borrowers or contractors are required to obtain all licenses and permits required by local governmental authorities. HUD requires lenders to ensure that contractors meet licensing requirements, and that repairs and improvements must comply with any local codes and ordinances.

Comment 6

However, Housing suggests that a revision be made to Recommendation 1I, regarding requiring the Mortgagee to *certify* to the determination that the work required building permits and that contractors were required to be licensed or certified to perform the repairs. Since the Mortgagee's role is to underwrite the mortgage to ensure compliance with FHA's requirements, Mortgagee staff do not have the knowledge to render a certification pertaining to building permit requirements and contractor licensing requirements for a multitude of jurisdictions throughout the United States. Such a requirement would likely undermine a Mortgagee's willingness to participate in the 203(k) program.

Single Family suggests the following wording as an alternative to address this concern:

Single Family Housing should revise HUD's policy or implement a new policy requiring lenders to review the scope of the repairs or renovations and determine whether the (1) building permits are likely to be required for the work and (2) contractors meet jurisdictional licensing and bonding requirements.

Ref to OIG Evaluation	Auditee Comments

Comment 7

Specific comment 2: Similarly, Housing suggests that a revision be made to Recommendation 1J, regarding the training of borrowers that participate in the 203(k) program. Single Family agrees that FHA should provide training to Mortgagees regarding its programs; but it is the Mortgagee's responsibility to communicate FHA's policies to their client borrowers. FHA does not provide training directly to borrowers, and Housing recommends that the reference to training borrowers be stricken from this Recommendation.

Comment 8

Specific comment 3: Housing is confused about the indication of loan eligibility related to "funds put to better use" in the Appendix, as it seems that terminology is more often reflective of funds that could be saved by the government. In this case, of course, the dollar volume represented is an estimate of funds that, though extrapolated, might have been saved by borrowers under the 203(k) Program. Housing notes that the report and findings do not evidence that any 203(k) loans studied were discovered to be ineligible under Program guidelines.

Comment 9

Specific comment 4: Finally, Housing suggests revisions be made to recommendations 2A and 2C regarding reference to adjustments to loan amortization schedules. Housing notes that a change to the premium amount or cancellation schedule of the premium does not affect the amortization of the mortgage.

Thank you for the opportunity to provide these comments on the draft audit report. I hope you find that they are helpful and that our review contributes to a final report which most appropriately reflects Housing's administration of the 203(k) Program.

OIG Evaluation of Auditee Comments

Comment 1 HUD acknowledged that some procedural and system updates are needed to better control risks associated with the 203(k) program. Further, it stated that it agrees that clarification of 203(k) related policy was needed, and this was accomplished with its recent publication of the new FHA Handbook 4000.1, which becomes effective on September 14, 2015.

We commend HUD for including clarification on 203(k) related policy in its new FHA Handbook 4000.1. We reviewed the origination section of the handbook, and determined that HUD had addressed recommendations 1K and 2D. However, since the new handbook would not be effective until September 14, 2015, these recommendations will remain in the audit report and addressed during the management decision process.

Further, HUD Handbook 4000.1 does not fully address all the issues cited in the audit report. For example, the handbook does not address how (1) lenders are to ensure that building permits are obtained for repairs when required by local government authorities and (2) contractors and sub-contractors are licensed. Therefore, additional procedural and system updates are still needed.

Comment 2 HUD noted that the language in the draft audit report with respect to FHA's efforts at managing its program risk related to the 203(k) product. Further, Housing stated that the very nature and design of the FHA program, with underwriting authority delegated to FHA-approved lenders, assumes some measure of risk-taking. With finite resources with which to manage program, operational, counterparty, and credit risks, Housing faces practical limits in its capacity to ensure that lenders comply with 203(k) program requirements in every instance.

We acknowledge (1) that HUD has finite resources and (2) the risks involved in administering the 203(k) program. However, as detailed in the audit report, HUD's current controls for monitoring lenders for compliance could be improved or enhanced to reduce the risk to the Mutual Mortgage Insurance Fund. We reconsidered and revised the language for finding 1 to state that "HUD needs to improve its monitoring and oversight of lenders' compliance with the Section 203(k) program requirements because lenders did not ensure that (1) borrowers or contractors obtained building permits to rehabilitate properties and (2) contractors were licensed or certified to perform rehabilitation work."

Comment 3 HUD stated that it believes that it has controls in place to monitor lender compliance with 203(k) program requirements, which had been evidenced to be appropriate especially as related to the scope of the Section 203(k) program. It also stated that during the period covered by the draft audit report, Housing staff

reviewed approximately 430,000 loans for compliance; almost 2 percent of this sample were 203(k) loans.

We acknowledge the Section 203(k) loan program portfolio is small in comparison to FHA's forward mortgages. However, assessing risks associated with the 203(k) program should not be based solely on the size of its portfolio. The 203(k) program loan is a two-tier loan designed to finance both the acquisition costs and the costs of property improvements into one mortgage loan; thus, making it a risker loan than the Section 203(b) mortgage loan. Essentially, FHA insures a 203(k) loan before the condition and value of the property offers adequate security. According to U.S. General Accounting Office (GAO) report GAO/RCED-99-124 issued in June 1999, the Section 203(k) program was more risky than the 203(b) single family loan program because the Section 203(k) program possesses both the risk of a traditional mortgage and the risk of a construction loan. Further, in its May 2013 Insights report, the Office of the Comptroller of the Currency (OCC) stated that the construction phase of the 203(k) program presents the highest risk of loan default.

Underwriting and approving 203(k) loans involve (1) reviewing borrowers' income and credit risks and (2) determining whether repairs are eligible and in compliance with the 203(k) rehabilitation requirements. As a result, besides ensuring borrowers meet income and credit risk underwriting requirements, HUD needs to improve its controls to ensure (1) the repairs to properties are in compliance with building codes, (2) borrowers live in safe and sanitary housing; and (3) HUD's interests are properly protected. The review of borrowers' income and credit underwriting analysis was not our audit objective.

Comment 4 HUD stated that the report cites roughly 40 loans with alleged violations of FHA policy and notes that almost 85 percent of the violations were related to permits not being obtained before the start of construction. However, FHA does not require copies of building permits to be included in the endorsement case binder, and the absence of a building permit is not sufficient evidence that the borrower or the borrower's contractor did not obtain such documentation.

The report cited that 55 of the 192 loans reviewed (more than 28 percent) were not in compliance with FHA's policy. We acknowledge that more than 80 percent of the cited deficiencies were related to licensing and permits and that FHA does not require lenders to include the building permits in the endorsement case binder. However, as a part of our review procedures, we contacted both the lenders and appropriate local government authorities to verify whether building permits were obtained for repairs when required. Therefore, we did not solely rely on the documents included in the loan files. HUD Handbook 4240, REV-2, section 4-9, requires that all licenses and permits be obtained as required by local government authorities, and the lender (direct endorsement underwriter) should be assured that these requirements have been satisfied and fees had been paid before

draw releases can be given. However, the contractor licenses and building permits were not obtained as required for the cited loans.

Comment 5 HUD contended that the requirement to obtain a building permit when necessary was that of the borrower or contractor, not the FHA-approved lender. Thus, Housing believes that the loans were compliant with FHA requirements.

Although we agree that HUD specified in the rehabilitation loan agreement form that all licenses and permits required by local governmental authorities to rehabilitate the property should be obtained by the borrower or contractor, it is the lender's responsibility to ensure that the requirements have been satisfied and the fees have been paid before it releases the draw to contractors, as specified in the HUD handbook 4240, REV-2, section 4-9.

Comment 6 HUD suggested we revise the recommendation 1I regarding requiring the lender to certify to the determination that the work required building permits and that the contractors were required to be licensed or certified to perform repairs. HUD stated that the lenders' staffs do not have the knowledge to render a certification pertaining to building permit requirements and contractor licensing requirements for multitude of jurisdictions throughout the United States. Such requirement would likely undermine a lender's willingness to participate in the 203(k) program.

We acknowledge that there are requirements for the multitude of jurisdictions throughout the United States. However, it is the lender's responsibility to ensure that these requirements have been satisfied and the fees have been paid before funds are paid to contractors, as specified in the HUD Handbook 4240, REV-2. Currently, HUD does not have a requirement concerning how lenders are to ensure contractors or borrowers determine whether building permits and licensing are required and obtained. Thus, we considered the suggested wording and revised recommendation 1I accordingly, recommending that HUD's policy require lenders to maintain documentation supporting their review and determination concerning required contractor licensing and building permits.

Comment 7 HUD suggested we revise recommendation 1J regarding the training of borrowers that participate in the 203(k) program. As suggested, we revised recommendation 1J accordingly, removing the reference to training borrowers that was included in the draft report.

Comment 8 HUD expressed its confusion about the indication of loan eligibility related to "funds put to better use" in appendix A of the draft report. Further, it stated that the report and findings do not evidence that any 203(k) loans studied were discovered to be ineligible under the program guidelines.

We reconsidered our definition of funds to be put to better use and revised the definition in appendix A accordingly, to reflect the future savings in mortgage insurance premium dollars to the borrowers who participate in the Section 203(k) program.

Apart from reviewing the selected loans for computation of the borrowers' monthly mortgage insurance premiums, our review was generally limited to verifying lenders' compliance with HUD's 203(k) requirements; specifically regarding contractor licensing, building permits, and the eligibility of work items under the Standard (k) and Streamlined (k) programs. We did not focus our review on the borrower's income, credit, or funds to close, to determine a loan's eligibility for FHA insurance under the 203(k) program. Additionally, we do not provide assurance that no other issues exist with the loans reviewed during the audit.

Comment 9 HUD suggested that we revise recommendations 2A and 2C regarding reference to adjustments to loan amortization schedules. We agree and revised recommendations 2A and 2C accordingly to specifically address borrowers' monthly mortgage insurance premiums. Further, for the logical organization of the recommendations, we have switched the order of recommendations 2A and 2B cited in the discussion draft audit report, which are now recommendations 2B and 2A, respectively for the final audit report.

Appendix C

Criteria

Finding 1

HUD Handbook 4240.4, REV-2, paragraph 3-2(C), states that the improvements must comply with HUD's minimum property standards (24 CFR (Code of Federal Regulations) 200.926(d) or HUD Handbook 4905.1) and all local codes and ordinances. Further, cost estimates must include labor and materials sufficient to complete the work. Home buyers doing their own work cannot eliminate the cost estimate for labor because if they cannot complete the work, there must be sufficient money in the escrow account to hire a subcontractor to do the work.

HUD Handbook 4240.4, REV-2, section 4-9, states that at loan closing, the mortgage proceeds disbursed by the lender and the cash from the borrower must equal the total cost of acquisition or refinance. The lender must establish the rehabilitation escrow account and place into the account the total amount to finance the construction plus the contingency reserve, inspection fees, and any mortgage payments when applicable. Additionally, the borrower must obtain all licenses and permits that are required by local governmental authorities. Draw releases cannot be given until the field office or direct endorsement underwriter is assured that these requirements have been satisfied and the fees have been paid.

HUD Handbook 4240.4, REV-2, appendix 2, Rehabilitation Loan Agreement, item 8, states that the borrower should cause all improvements to be made in a workmanlike manner and in accordance with all applicable statutes and regulations. All licenses, permits, and privileges required by local governmental authorities to rehabilitate the property should be obtained by the borrower(s) or contractor.

HUD Handbook 4155.2, paragraph 8.B.2.b, states that the documents in the case binder for the Section 203(k) program must include but are not limited to the rehabilitation agreement, work writeups, cost estimates, draw request, 203(k) borrower's acknowledgment, borrower's identity-of-interest certification, homeowner or contractor agreement(s), and 203(k) consultant identity-of-interest statement.

Mortgagee Letter 2005-50 states that while lenders are not contractors, participation in the Streamlined (k) program requires that they examine the contractor's bid(s) and determine that they fall within the usual and customary range for similar work. Lenders must also ensure that the selected contractor(s) meet all jurisdictional licensing and bonding requirements. Further, if "self-help" arrangements are used, the borrower must provide written estimates from the suppliers of the materials. Those repairs and improvements must comply with any local codes and ordinances, and the borrower or contractor must obtain all required permits before starting the work. The cost estimate(s) must clearly state the nature and type of repair and the cost for completion of the work item. Further, major rehabilitation or major remodeling, such as the relocation of a load-bearing wall and repair of structural damage, are not eligible for financing under the Streamlined (k) program.

HUD's Valuation Protocol Frequently Asked Questions – Environment Protection Agency's New Lead-Based Paint Rule states that on April 22, 2010, the Environmental Protection Agency changed its requirements regarding renovation, repair, and painting for houses built before 1978 as follows:

- Homeowners performing renovation, repair, or painting work on their own home are exempt from the rule but are encouraged to learn to perform lead-safe work practices.
- Property owners or landlords who renovate, repair, or prepare surfaces for painting in pre-1978 rental housing must be certified and follow lead-safe work practices required by the rule.
- Contractors who perform the repair must be certified and must follow specific work practices to prevent lead contamination.

HUD's Post Endorsement Technical Review Desk Guide, dated October 2010, chapter 1, states that the postendorsement technical review process is one of several FHA processes used to help monitor and mitigate risk to the FHA insurance fund by conducting technical reviews on a selection of postendorsement loans to ensure lender compliance with FHA credit and valuation policies and procedures. These reviews help to identify areas of lender origination noncompliance, permitting FHA to require corrective actions to mitigate risk, including indemnification or referral to the Mortgagee Review Board. In addition, chapter 4 states that reviewing the case file in a thorough and analytical manner is crucial to protecting the FHA insurance fund. FHA depends on the experience and expertise of underwriters and appraisers to use their training, experience, and analytical skills when reviewing case files to determine whether a lender complies with FHA policies and guidelines when underwriting loans to be insured by FHA. A successful reviewer must have the ability to comprehensively evaluate the data contained within the entire file and then determine whether the file presents an acceptable risk to the FHA insurance fund.

Finding 2

Requirements of 12 U.S.C. (United States Code) 1709(c)(2)state that the HUD Secretary must establish and collect, at the time of insurance, a single premium payment in an amount not exceeding 3[43] percent of the amount of the original insured principal obligation of the mortgage. In the case of a mortgage for which the borrower is a first-time home buyer who completes a program of counseling with respect to the responsibilities and financial management involved in home ownership that is approved by the Secretary, the premium payment under this subparagraph must not exceed 2.75 percent of the amount of the original insured principal obligation of the mortgage. Upon payment in full of the principal obligation of a mortgage before the maturity date of the mortgage, the Secretary must refund all of the unearned premium charges paid on the mortgage under this subparagraph, provided that the borrower refinances the unpaid principal obligation under this subchapter. In addition to the premium under subparagraph (A), the Secretary must establish and collect annual premium payments in an

[43] The upfront premium changes throughout the years. Refer to applicable HUD mortgagee letters in this appendix for applicable changes.

amount not exceeding 0.50 percent of the remaining insured principal balance (excluding the portion of the remaining balance attributable to the premium collected under subparagraph (A) and without taking into account delinquent payments or prepayments) for the following periods:

"(i) For any mortgage involving an original principal obligation (excluding any premium collected under subparagraph (A)) that is less than 90 percent of the appraised value of the property (as of the date the mortgage is accepted for insurance), for the first 11 years of the mortgage term. (ii) For any mortgage involving an original principal obligation (excluding any premium collected under subparagraph (A)) that is greater than or equal to 90 percent of such value, for the first 30 years of the mortgage term; except that notwithstanding the matter preceding clause (i), for any mortgage involving an original principal obligation (excluding any premium collected under subparagraph (A)) that is greater than 95 percent of such value, the annual premium collected during the 30-year period under this clause should be in an amount not exceeding 0.55 percent[44] of the remaining insured principal balance (excluding the portion of the remaining balance attributable to the premium collected under subparagraph (A) and without taking into account delinquent payments or prepayments)."

HUD Handbook 4155.2, paragraph 7.3.c, states that for loans closed on or after January 1, 2001, with terms of more than 15 years, FHA's annual mortgage insurance premium is automatically canceled when the loan-to-value ratio reaches 78 percent, provided the borrower paid the annual mortgage insurance premium for at least 5 years. For loans with terms of 15 years and less and loan-to-value ratios 90 percent and greater, FHA's annual mortgage insurance premium is automatically canceled when the loan-to-value ratio reaches 78 percent, regardless of the length of time the borrower has paid the annual mortgage insurance premium. For the mortgages with terms of 15 years and less and loan-to-value ratios of 89.99 percent and less, FHA does not charge borrowers annual mortgage insurance premiums.

HUD Handbook 4240.4, REV-2, section 1-10, states that the maximum mortgage calculation is based on the lesser of (1) the estimate of as-is value or the purchase price of the property before rehabilitation, whichever is less, plus the estimated cost of rehabilitation and allowable closing costs or (2) 110 percent of the expected market value of the property upon completion of the work plus allowable closing costs.

Mortgagee Letter 2008-22 states that effective with new FHA case number assignments on or after October 1, 2008, FHA will no longer base its mortgage insurance premiums on a combination of the credit bureau score and loan-to-value ratio. FHA will charge an upfront premium in an amount equal to 1.75 percent of the mortgage for purchase money mortgages and full-credit qualifying refinance. In addition to the upfront premium, FHA will charge an annual premium based on the initial loan-to-value ratio and length of the mortgage. For loans with mortgage terms greater than 15 years and a loan-to-value ratio less than or equal to 95 percent, the annual rate is .50 percent; with a loan-to-value ratio greater than 95 percent, the annual rate is .55 percent. Further, for insurance premium purposes and eligibility for FHA mortgage

[44] See Mortgagee Letters 2010-02, 2010-28, 2011-10, and 2012-04 for applicable upfront mortgage insurance premium and annual mortgage insurance premium rates.

insurance, the loan-to-value ratio,[45] computed to two decimals, is calculated by dividing the mortgage amount, before adding on an upfront mortgage insurance premium, by the sale price or appraised value, whichever is less. For refinance transactions, which often include closing costs in the loan amount, the loan-to-value ratio is determined by dividing the loan amount, before adding on an upfront mortgage insurance premium, by the appraiser's estimate of value.

Mortgagee Letter 2010-02 states that effective for FHA loans for which the case number is assigned on or after April 5, 2010, FHA will collect an upfront mortgage insurance premium of 2.25 percent. The annual premium will not change at this time.

Mortgagee Letter 2010-28 states that effective for FHA loans for which the case number is assigned on or after October 4, 2010, FHA will lower the upfront premium to 1 percent (from 2.25 percent). In addition, for mortgages involving an original principal obligation of less than or equal to 95 percent of the appraised value of the property, the amount of the authorized annual premium is increased to 0.85 percent (from 0.50 percent) of the remaining insured principal balance. For mortgages involving an original principal obligation that is greater than 95 percent of the appraised value of the property, the amount of the authorized annual premium is increased to 0.90 percent (from 0.55 percent) of the remaining insured principal balance.

Mortgagee Letter 2011-10 states that effective for FHA loans for which the case number is assigned on or after April 18, 2011, with a mortgage term greater than 15 years, for mortgages involving an original principal obligation of less than or equal to 95 percent of the appraised value of the property, the amount of the authorized annual premium is increased to 1.10 percent (from .85 percent) of the remaining insured principal balance. For mortgages involving an original principal obligation that is greater than 95 percent of the appraised value of the property, the amount of the authorized annual premium is increased to 1.15 percent (from 0.90 percent) of the remaining insured principal balance. The upfront premium remains the same (1 percent).

Mortgagee Letter 2012-04 states that effective for FHA loans for which the case number is assigned on or after April 9, 2012, with mortgage terms greater than 15 years, for mortgages involving an original principal obligation of less than or equal to 95 percent of the appraised value of the property, the amount of the authorized annual premium is increased to 1.2 percent (from 1.10 percent) of the remaining insured principal balance. For mortgages involving an original principal obligation that is greater than 95 percent of the appraised value of the property, the amount of the authorized annual premium is increased to 1.25 percent (from 1.15 percent) of the remaining insured principal balance. In addition, FHA increased the upfront premium from 1 to 1.75 percent of the base loan amount.

Mortgagee Letter 2013-04 states that effective for FHA loans for which the case number is assigned on or after June 3, 2013, for all mortgages, regardless of their amortization terms, any mortgage involving an original principal obligation (excluding financed upfront mortgage insurance premium) less than or equal to 90 percent loan-to-value ratio, the annual mortgage insurance premium will be assessed until the end of the mortgage term or for the first 11 years of

[45] The instruction for calculating the loan-to-value ratio in HUD's Mortgagee Letter 2008-22 does not mention whether it was also applicable to the 203(k) loans.

the mortgage term, whichever occurs first. For any mortgage involving an original principal obligation (excluding financed upfront mortgage insurance premium) with a loan-to-value ratio greater than 90 percent, FHA will assess the annual mortgage insurance premium until the end of the mortgage term or for the first 30 years of the term, whichever occurs first. Additionally, for case numbers assigned on or after April 1, 2013, it increased the annual mortgage insurance premium from 1.20 to 1.30 percent if the loan-to-value ratio is less than or equal to 95 percent and 1.25 to 1.35 percent if loan-to-value ratio is greater than 95 percent.

Computerized Homes Underwriting Management System manual, dated November 2011, paragraph 4.5.2c, states that for 203(k) loans endorsed on or after November 12, 2008, the ratio of the mortgage (without upfront mortgage insurance premium) to the lesser of the appraised value or the sum of the sales price plus repair amount is used for the loan-to-value ratio.

HUD's Office of General Counsel's legal opinion clarifying the calculation of the mortgage insurance premium for 203(k) loans, dated July 29, 2013, states that for purposes of determining the obligation to pay the mortgage insurance premium, the mortgage insurance premium is calculated based on the original principal balance. The period for payment of the insurance premium is established based on the appraised value at the time of endorsement, which may differ from the value used to determine the maximum insured value for a 203(k) loan. There are no further calculations necessary for closing costs or repair costs because the calculation of the mortgage insurance premium is based solely on the appraised value[46] of the property as of the date the mortgage is accepted for insurance.

OIG's Office of Legal Counsel's legal opinion regarding the definition of appraised value for determining borrowers' monthly mortgage insurance premium, stated that HUD's Computerized Homes Underwriting Management System contradicts the statute and the statute controls. Counsel opined that the appraised value as it pertains to Section 203(k) Rehabilitation Mortgage Insurance Program is the after-improved value of the property and should be applied consistently when calculating mortgage premiums.

[46] HUD's Home Mortgage Insurance Division's working group further clarified that the after-improved value (the value according to the appraisal report as determined by the appraiser) should be the only appraised value used for calculating the loan-to-value ratio for determining borrowers' monthly mortgage insurance premiums.

Appendix D

Schedule of Lender Compliance Deficiencies

	FHA case number[47]	Permits not obtained before construction started	No evidence contractor had a specialty license to perform repair	No lead-based paint certification	Unclear cost estimate	Other issue
1	137-5861827				X	
2	264-0943855	X				
3	061-4391510	X				
4	446-0244535	X		X		
5	221-4986227	X	X			
6	023-3940503	X				
7	412-7073745	X	X			
8	251-5012404	X	X			
9	566-0363087	X				
10	263-4726983	X	X			
11	461-4837349	X				
12	137-6191569	X				
13	011-6367805	X				
14	277-1529457	X	X			
15	544-0339793	X	X			
16	241-9717127	X				
17	341-1255632	X				
18	093-6893539	X				
19	052-6270908	X				
20	197-5774289	X				
21	251-4327095	X	X			
22	548-5367429	X	X			
23	566-0021633	X				
24	137-7354506	X	X			
25	091-5004081	X			X	
26	412-7541464	X[48]				
27	412-7029735	X				
28	264-1301039[49]		X			

[47] FHA case numbers 061-4391510 and 251-4327095 were paid in full as of January 2015.

[48] As a result of local code violations, the required building permits were obtained ***after*** the repairs and renovations were completed. The repairs and renovation associated with issued permits were inspected by the local city authority. Therefore, we did not request the unsupported cost.

[49] There was no evidence that the contractor had a specialty trade license for the repairs; however, permits were obtained by the borrowers, and repairs passed the local city inspection. Thus, we did not question the cost.

Schedule of Lender Compliance Deficiencies (Concluded)

	FHA case number	Permits not obtained before construction started	No evidence contractor had a specialty license to perform repair	No lead-based paint certification	Unclear cost estimate	Other issue
29	251-4669942[50]		X			
30	264-0785150			X		
31	277-1310097			X		
32	044-5206203	X				
33	412-7011576[51]	X	X			
34	413-5745825	X	X			
35	352-7227989	X	X			
36	241-9513470	X				X[52]
37	263-5007325	X				
	Totals	**32**	**14**	**3**	**2**	**1**

[50] There was no evidence to support that the contractor had a specialty license to perform the repairs; however, the borrower obtained all required permits, and the work passed the local city inspection. Thus, we did not question the cost.
[51] FHA case number 412-7011576 was paid in full as of January 2015.
[52] The contractor did not sufficiently address all the repairs that were identified on the appraisal.

Appendix E

Schedule of HUD Review Deficiencies

	FHA case number[53]	Permits not obtained before construction started	No evidence contractor had a specialty license	No lead-based paint certification	Unclear cost estimate	Other issues
1	023-4597598	X		X		
2	501-8198149		X		X	X[54]
3	501-8290589	X			X	
4	501-8474260	X			X	
5	249-5834018	X	X			
6	137-6358439	X	X			
7	061-4106346	X				
8	251-4486882	X				
9	451-1165810					X[55]
10	137-6895748	X[56]	X			
11	042-9383114	X				
12	052-6519334	X				
13	374-6193319	X				
14	277-1438986					X[57]
15	374-6097723			X		
16	197-4944463	X				
17	052-4308836				X	
18	043-8239100				X	
	Totals	**12**	**4**	**2**	**5**	**3**

[53] FHA case numbers 249-5834018, 042-9383114, 197-4944463, and 374-6097723 were paid in full as of January 2015.
[54] There was no evidence that the repairs indicated in the direct endorsement underwriter form, form HUD-54114, were adequately addressed.
[55] The cost estimate prepared by the HUD-approved consultant did not separate the costs for labor and materials. Therefore, we could not determine whether the borrower was reimbursed only for the cost of materials.
[56] Required building permits were obtained after the repairs and renovation were completed as a result of local code violations. The repairs and renovations associated with the issued permits were inspected by the local city authority. Therefore, we did not question the unsupported cost.
[57] Appraiser conditioned on the appraisal report that peeling paint in the stairwell needed to be repaired to meet minimum property standard but was not addressed by the contractor.

Appendix F

Estimated Losses to HUD From Deficiencies

	FHA case number	Unpaid principal balance[58]	Estimated losses				
			Recommendation 1A	Recommendation 1B	Recommendation 1C	Recommendation 1D	Recommendation 1E
1	011-6367805	$120,647	$5,270				
2	023-3940503	235,625	31,901				
3	023-4597598	84,254	31,780				
4	044-5206203	300,689	30,308				
5	052-6270908	116,756	7,590				
6	052-6519334	223516	10,088				
7	061-4106346	102,651	23,344				
8	093-6893539	75,519	14,836				
9	137-6191569	130,291	26,560				
10	137-6358439	120,818	27,435				
11	137-7354506	152,256	121,736				
12	197-5774289	197,765	14,263				
13	221-4986227	255,879	58,108				
14	241-9717127	141,091	13,651				
15	251-4486882	197,452	21,938				
16	251-5012404	276,950	67,085				
17	263-4726983	60,409	10,174				
18	263-5007325	123,831	32,365				
19	264-0943855	45,420	5,346				
20	277-1529457	170,491	15,443				
21	341-1255632	104,557	10,382				
22	352-7227989	146,211	17,890				
23	374-6193319	256,068	10,075				
24	412-7029735	67,277	11,878				
25	412-7073745	44,874	21,485				
26	413-5745825	71,799	22,912				
27	446-0244535	140,019	9,962				
28	461-4837349	67,474	20,695				
29	544-0339793	76,638	24,804				
30	566-0021633	117,681	33,483				
31	566-0363087	115,664	8,400				
32	548-5367429	155,100	31,650				
33	501-8290589	114,749		$57,375			
34	501-8474260	86,520		43,260			
35	137-5861827	142,280		71,140			
36	091-5004081	100,596		50,298			
37	052-4308836	0		61,363			
38	043-8239100	0		21,959			
39	451-1165810	167,429			$83,715		
40	501-8198149	78,733				$39,367	
41	241-9513470	105,322					$52,661
42	277-1438986	$89,387					44,694
	Totals	**$5,380,688**	**$792,837**	**$305,395**	**$83,715**	**$39,367**	**$97,355**

[58] Unpaid principal balance for active FHA insurance loans downloaded from HUD's Single Family Data Warehouse as of January 2015. HUD paid claim on two loans, FHA case numbers 052-4308836 and 043-8239100.

Appendix G

Schedule of Overcalculated Loan-to-Value Ratio Deficiencies

	FHA case number	Loan-to-value ratio calculated by HUD's System	Loan-to-value ratio calculated by OIG	Borrower overpaid monthly premium	Total amount of overpaid premium through Sept. 2014	Borrowers would pay premiums for additional months	Incorrect data entered into FHA Connection		
							Estimate	Sale price[59]	Repair escrow amount
1	277-1777708	96.49%	94.43%	X	$247	X	X		
2	156-1664066	96.49%	95.93%		0	X			
3	352-7829014	96.49%	84.05%	X	106	X	X		
4	105-7187318	100.22%	97.38%		0	X			X
5	137-5665261	94.07%	78.07%		0	X		X	
6	352-7148959	96.49%	75.07%	X	255	X			
7	501-8500108	97.52%	67.24%	X	59	X			X
8	251-4791488*	97.05%	77.15%	X	232	X			X
9	387-1395159	96.49%	93.73%	X	57	X	X		
10	052-7035272	97.70%	85.20%	X	167	X			
11	332-5379521	96.49%	86.02%	X	459	X			
12	412-7531161	96.49%	88.12%	X	40	X	X	X	
13	264-0943855	84.96%	73.94%		0	X		X	X
14	263-4726983	96.49%	91.57%	X	147	X			
15	372-4184540	96.49%	84.08%	X	95	X	X	X	X
16	422-3176468*	96.49%	96.17%		0	X			
17	292-5995474	96.50%	86.34%	X	118	X			
18	446-0719569*	97.49%	72.75%	X	108	X			X
19	501-8409794	100.27%	75.92%	X	93	X			X
20	446-0654308	95.40%	89.14%	X	143	X			X
21	263-4702841	96.49%	76.46%	X	189	X			
22	105-4680866	96.49%	74.84%	X	309	X			
23	441-8836210	95.84%	87.37%	X	111	X			
24	093-7523939	90.02%	83.55%		0	X	X	X	
25	411-5077139	96.50%	73.93%	X	72	X	X		
26	544-0339793	96.50%	64.09%	X	64	X	X		

**Legend - ***FHA case numbers with an asterisk (*) presented loans paid in full as of January 1, 2015.

[59] For a refinanced loan, lenders would enter a borrower's unpaid principal balance into FHA Connection rather than the property's sale price.

Schedule of Overcalculated Loan-to-Value Ratio Deficiencies (Continued)

	FHA case number	Loan-to-value ratio calculated by HUD's System	Loan-to-value ratio calculated by OIG	Borrower overpaid monthly premium	Total amount of overpaid premium through Sept. 2014	Borrowers would pay premiums for additional months	Incorrect data entered into FHA Connection		
							Estimate	Sale price	Repair escrow amount
27	264-1301039	96.49%	92.93%	X	$70	X	X		
28	048-7080310	96.49%	95.92%		0	X	X	X	
29	105-7078213	96.49%	94.37%	X	109	X			X
30	201-5269369	97.79%	81.39%	X	70	X			X
31	412-7541464	96.49%	86.27%	X	83	X	X		
32	581-4664948	96.50%	80.49%	X	81	X	X		X
33	221-4909890*	96.49%	62.50%	X	72	X			
34	181-2700596	96.49%	87.39%	X	168	X			
35	413-5640987	96.49%	95.75%		0	X			
36	387-1318640	96.49%	91.07%	X	107	X			
37	492-9113318	97.00%	95.70%		0	X			X
38	566-0363087	96.48%	93.85%	X	193	X			
39	221-4557177	88.53%	87.99%		0	X		X	
40	277-0408863*	99.12%	98.85%		0	X			X
41	374-5556132	97.02%	65.28%	X	279	X			X
42	446-0250899	96.49%	89.69%	X	211	X			
43	566-0021633	96.47%	82.73%	X	250	X			
44	105-4643472	99.90%	88.90%	X	275	X	X		
45	501-7905081	96.76%	94.81%	X	315	X	X		X
46	277-1436224	96.49%	95.70%		0	X			
47	061-4045269	96.86%	88.31%	X	231	X			X
48	387-0931290	94.65%	92.55%		0	X			
49	481-3335469	97.13%	93.27%	X	224	X			X
50	137-6191569	96.49%	86.29%	X	239	X			
51	566-0177026	96.48%	94.22%	X	279	X			
52	182-1193066	96.49%	61.93%	X	53	X	X		
53	446-0244535	96.72%	81.04%	X	304	X	X		X
54	156-0289929	89.91%	84.67%		0	X		X	X
55	061-4391510*	96.49%	84.60%	X	117	X	X		
56	277-1529457	96.49%	83.46%	X	172	X	X		
57	156-0777800	96.86%	71.10%	X	141	X			X
58	011-6367805	92.65%	83.00%	X	249	X		X	
59	137-5987962	93.28%	78.82%		0	X			X
60	221-4986227	96.18%	75.47%	X	181	X	X		
61	341-1375139	96.49%	82.19%	X	135	X			
62	231-1212449	101.15%	94.80%	X	171	X			X

Schedule of Overcalculated Loan-to-Value Ratio Deficiencies (Concluded)

	FHA case number	Loan-to-value ratio calculated by HUD's System	Loan-to-value ratio calculated by OIG	Borrower overpaid monthly premium	Total amount of overpaid premiums through Sept. 2014	Borrowers would pay premiums for additional months	Incorrect data entered into FHA Connection		
							Estimate	Sale price	Repair escrow amount
63	251-5052715	96.43%	86.46%	X	$167	X	X		
64	352-7504706	96.49%	89.08%	X	285	X	X	X	
65	412-7484656	96.49%	92.80%	X	160	X			
66	501-8492625	96.49%	72.34%	X	207	X			
67	581-4452607*	96.49%	96.07%		$0	X	X		
68	352-7317194	105.94%	94.84%	X	264	X			X
69	541-9603091	96.68%	83.38%	X	261	X			X
70	043-8233137*	96.49%	94.24%	X	297	X			
71	221-4622406*	88.32%	82.86%		0	X		X	
72	371-4256486	96.67%	90.88%	X	410	X			X
73	451-1035298	96.49%	88.05%	X	478	X	X		
74	412-6267818	103.81%	97.38%		0	X			X
75	251-5012404	96.49%	94.92%	X	279	X			
76	081-1008837*	96.96%	94.65%	X	575	X			X
77	411-4915136	96.50%	95.35%		0	X			
78	374-5946100	100.09%	94.45%	X	598	X	X		
79	352-6987789*	96.76%	90.99%	X	623	X			X
80	277-1492783	96.49%	83.60%	X	122	X	X		
	Totals			**61**	**$12,576**	**80**	**25**	**11**	**28**

**Legend - ***FHA case numbers with an asterisk (*) presented loans paid in full as of January 1, 2015.

Appendix H

Schedule of Undercalculated Loan-to-Value Ratio Deficiencies

	FHA case number	Loan-to-value ratio as calculated by HUD's System	Loan-to-value ratio calculated by OIG	Borrower underpaid monthly premium	Total amount of underpaid premium through Sept. 2014	Borrower would pay premiums for fewer months	Incorrect data entered into FHA Connection		
							Estimate	Sale price[60]	Repair escrow amount
1	093-6893539	96.49%	100.34%		$0	X	X	X	
2	156-1541251	93.64%	103.01%	X	68	X	X	X	
3	094-6448960	93.63%	103.00%	X	90	X	X		
4	446-1464771	96.49%	97.42%		0	X	X		
5	023-4444095	96.49%	102.45%		0	X	X		
6	544-0538777	96.50%	99.99%		0	X	X		
7	251-4669942	106.15%	108.18%		0	X	X		X
8	332-4872169	98.83%	102.13%		0	X	X		
9	372-4544873	96.49%	99.56%		0	X	X		
10	562-2337382	97.14%	97.57%		0	X	X		X
11	442-3644053	96.46%	106.12%		0	X	X	X	X
12	044-4545929	96.49%	97.68%		0	X	X	X	
	Totals			**2**	**$158**	**12**	**12**	**4**	**3**

[60]For a refinanced loan, lenders would enter a borrower's unpaid principal balance into FHA Connection rather than the property's sale price.