



Office of Single Family Housing, Washington, DC

Oversight of Safe Water Requirements for FHA- Insured Loans Nationwide



To: Gisele Roget, Deputy Assistant Secretary for Single Family Housing, HU
//signed//
From: David E. Kasperowicz, Regional Inspector General for Audit, Philadelphia
Region, 3AGA
Subject: HUD Did Not Provide Sufficient Guidance and Oversight To Ensure That FHA-
Insured Properties Nationwide Had Safe Water

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 safe water requirements for Federal Housing Administration (FHA)-insured loans nationwide.

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 website. 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 215-430-6734.



Audit Report Number: 2017-PH-0003

Date: September 29, 2017

HUD Did Not Provide Sufficient Guidance and Oversight To Ensure That FHA-Insured Properties Nationwide Had Safe Water

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) oversight of safe water requirements for Federal Housing Administration (FHA)-insured loans nationwide. We conducted the audit based on news reports that identified lead contamination in public water systems across the country and also because of an audit in which we found that HUD did not have adequate controls to ensure that FHA-insured properties located in Flint, MI, had safe water.¹ Our audit objective was to determine whether HUD provided sufficient guidance and oversight to ensure that properties approved for mortgage insurance had a continuing and sufficient supply of safe and potable water.

What We Found

HUD did not provide sufficient guidance and oversight to ensure that properties approved for mortgage insurance had a continuing and sufficient supply of safe and potable water. Of 49 loan files reviewed, from a universe of 1,432 properties connected to a public water supply for which a notice that it had lead contamination was issued to the public, none disclosed the contamination or contained evidence of water testing. This condition occurred because HUD maintained that its existing policies and guidance sufficiently ensured that FHA-insured properties had a continuing and sufficient supply of safe and potable water. HUD also lacked controls to determine whether appraisers notified lenders of properties in areas serviced by a public water system with unacceptable levels of contaminants. As a result, HUD could be endorsing loans for properties with contaminants that affect families' health. Further, if property values decrease due to the water quality issues, both HUD and the homeowner face an increased risk of loss.

What We Recommend

We recommend that HUD direct the applicable lenders to provide evidence that the properties for 1,383 FHA-insured loans had a safe and potable water source, or that the appraisers had not notified them of the water quality issue on their appraisals. If they cannot provide this evidence, direct them to perform water testing and any necessary remediation, or indemnify HUD against future loss. We also recommend that HUD improve its guidance and implement policies and procedures to ensure compliance, thereby putting at least \$238.1 million to better use.

¹ Audit Report 2016-PH-0003, HUD Did Not Ensure That Lenders Verified That FHA-Insured Properties in Flint, MI, Had Safe Water, issued July 29, 2016

Table of Contents

Background and Objective.....	3
Results of Audit	5
Finding: HUD Did Not Provide Sufficient Guidance and Oversight To Ensure That FHA-Insured Properties Nationwide Had Safe Water	5
Scope and Methodology.....	10
Internal Controls.....	13
Followup on Prior Audits	14
Appendixes.....	15
A. Schedule of Funds To Be Put to Better Use.....	15
B. Auditee Comments and OIG’s Evaluation.....	16
C. Notices of Lead Contamination in Seven Public Water Systems	23
D. Maps of FHA-Insured Properties Serviced by the Seven Public Water Systems That Issued Public Notices of Unacceptable Lead Levels.....	25
E. Responsibilities for Ensuring That FHA-Insured Properties Serviced by Public Water Systems Have Safe Water.....	34

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 is the largest insurer of mortgages in the world, insuring more than 41 million properties since its inception in 1934. FHA became a part of the U.S. Department of Housing and Urban Development (HUD) in 1965. HUD's single-family housing programs include mortgage insurance on loans to purchase or refinance new or existing homes. Because HUD insures the loan, lenders are able to offer borrowers low downpayments and low closing costs.

To be eligible for an FHA-insured loan, properties must meet minimum property requirements. HUD Handbook 4000.1² establishes standards and provides guidance on minimum property requirements that meet regulations at 24 CFR (Code of Federal Regulations) 200.926, including that properties have a sufficient supply of safe and potable water.³ The Safe Drinking Water Act⁴ requires the Environmental Protection Agency (EPA) to determine levels of contaminants in drinking water at which no adverse health effects are likely to occur with an adequate margin of safety. Certain contaminants are required to be tested more frequently than others. Because lead is a toxic metal harmful to human health, even at low exposure, EPA and the Centers for Disease Control and Prevention agree that there is no known safe level of lead in a child's blood. According to EPA, exposure to lead in drinking water may cause (1) cardiovascular issues, (2) increased blood pressure, (3) decreased kidney function, and (4) reproductive problems in adults. In addition, exposure to lead in drinking water can cause (1) behavior and learning problems, (2) lower IQs, (3) hyperactivity, (4) slowed growth, (5) hearing problems, and (6) anemia in infants and children. The importance of this point was emphasized by HUD Secretary Dr. Ben Carson during a 2017 hearing in front of the House Appropriations Committee. During his testimony, Dr. Carson stated, "I am particularly interested in creating healthy homes. As a physician, I can tell you any amount of lead in our children is too much."⁵

The Public Notification Rule of the Safe Drinking Water Act requires water systems to notify consumers of contamination if lead levels exceed 15 ppb (parts per billion) in more than 10 percent of samples, known as "action levels."⁶ Public water systems with action level contamination must notify customers either by media, posting a notice in a public place, or personally delivering them a notice. News reports have identified nearly 2,000 public water systems serving about 6 million people that have had lead contamination since 2012. Of those,

² HUD Handbook 4000.1 was implemented on September 14, 2015. It superseded appendix K of HUD Handbook 4910.1, which had the same guidance regarding minimum property requirements.

³ Potable water is defined as water that is suitable for drinking.

⁴ Public Law 93-523

⁵ Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, budget hearing, June 8, 2017

⁶ EPA sets its public health goal at zero but sets the action level that determines when public notification is required in its National Primary Drinking Water Regulations in 40 CFR 141.80(c).

600 had lead levels over 40 ppb, which is significantly more than twice the Safe Drinking Water Act action level and similar to the unsafe levels found in the water in Flint, MI.

No one knows how many public water systems are contaminated because not all violations are reported. In 2011, the Government Accountability Office (GAO) reported that EPA could not measure public water systems' compliance with its standards because the number of violations reported by public water systems to EPA were unreliable.⁷ As of June 2017, three recommendations from that GAO report were open, including one classified as a priority. In this recommendation, GAO recommended that EPA resume data verification audits to routinely evaluate the quality of drinking water data on health-based and monitoring violations that the States provide to it. Further, the EPA Office of Inspector General (OIG) reported that small water systems are less likely to properly monitor their water for contaminants, compared to larger water systems, and they violate EPA standards more often.⁸ The report also stated that 82 percent of all public water systems were classified as small. There are also inconsistencies in how and when emergency declarations are made. EPA OIG reported that EPA needed to clarify its authority to issue emergency orders in a timely manner to be better prepared and able to intercede in public health emergencies like that which occurred in Flint, MI.⁹

In July 2016, we issued an internal audit report on HUD's oversight of FHA-insured loans on properties in Flint, MI.¹⁰ We found that HUD did not ensure that lenders verified that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water. This condition occurred because HUD's existing controls were not designed to detect whether loan files contained evidence of water testing. The report included six recommendations, which are still open but targeted to be resolved by December 2017.

Our audit objective was to determine whether HUD provided sufficient guidance and oversight to ensure that properties approved for mortgage insurance had a continuing and sufficient supply of safe and potable water.

⁷ Drinking Water: Unreliable State Data Limit EPA's Ability to Target Enforcement Priorities and Communicate Water Systems' Performance, GAO-11-381, June 17, 2011

⁸ Drinking Water: EPA Needs to Take Additional Steps to Ensure Small Community Water Systems Designated as Serious Violators Achieve Compliance, Report No. 16-P-0108, March 22, 2016

⁹ Management Alert: Drinking Water Contamination in Flint, MI, Demonstrates a Need to Clarify EPA Authority to Issue Emergency Orders to Protect the Public, Project No. 17-P-0004, October 20, 2016

¹⁰ See footnote 1.

Results of Audit

Finding: HUD Did Not Provide Sufficient Guidance and Oversight To Ensure That FHA-Insured Properties Nationwide Had Safe Water

HUD did not ensure that properties it approved for mortgage insurance nationwide had a continuing and sufficient supply of safe and potable water. Of 49 loan files reviewed for properties connected to a public water supply for which a notice that it had lead contamination was issued to the public, none disclosed the contamination or contained evidence of water testing.¹¹ This condition occurred because HUD maintained that its existing policies and guidance ensured that lenders and appraisers understood and followed regulations requiring safe water for FHA-insured properties serviced by public water systems when they had excessive lead levels. HUD also lacked controls to determine whether appraisers notified lenders of properties in areas serviced by a public water system with unacceptable levels of contaminants. If lenders and appraisers do not understand when water testing is required and HUD does not provide oversight to ensure compliance with requirements, HUD could be endorsing loans for properties with contaminants that affect families' health. Further, if property values decrease because of the water quality issues, both HUD and the homeowner face an increased risk of loss. HUD could put at least \$238.1 million to better use if it develops and implements additional guidance to advise lenders and appraisers when water testing is required for properties serviced by a public water system that has issued a public notice of water contamination, and policies and procedures to ensure that appraisers comply with the guidance.

HUD Guidance Was Not Sufficient

HUD did not provide sufficient guidance to lenders and appraisers to ensure that properties it approved for mortgage insurance nationwide had a continuing and sufficient supply of safe and potable water. Regulations at 24 CFR 200.926d(f) and HUD Handbook 4000.1¹² state that properties are required to have a continuing and sufficient supply of safe and potable water. However, the Handbook does not mention when water testing is required for properties connected to a public water supply with unacceptable levels of contaminants. In response to the water contamination crisis in Flint, MI, HUD issued a questions and answers document on February 8, 2016, to remind lenders and other stakeholders involved with FHA transactions that to be eligible for FHA insurance, a property must meet FHA's property acceptability criteria.¹³ The document states that if the lender is aware that a property is located in an area serviced by a public water system with unacceptable levels of contaminants, a water test is required. However, HUD has not incorporated this or any other clarifying language into the Handbook. The Handbook states only that lenders must confirm that properties have a sufficient supply of safe

¹¹ See appendix C for a summary of the information contained in the notices.

¹² Section II, paragraph A.3.a.ii(F)

¹³ HUD Handbook 4000.1, section II, paragraphs A.3.a.ii(F) and (J)

and potable water, appraisers must comply with the Uniform Standards of Professional Appraisal Practice competency rule, and appraisers must notify lenders if the property does not have a continuing and sufficient supply of safe and potable water.

Loan Files Did Not Disclose That a Public Notice of Lead Contamination Was Issued or Contain Evidence of Water Testing

Loan files did not contain evidence to show that the properties had safe and potable water as required by 24 CFR 200.926d(f) and HUD Handbook 4000.1.¹⁴ We reviewed 49 of 1,432 loan files for properties serviced by 7 public water systems for which a notice that it had lead contamination was issued to the public to determine whether the files contained information about declared contamination and evidence that the water was safe.¹⁵ None of the 49 files contained information regarding the public notices that had been issued, nor did they contain evidence of water testing. As a result, HUD did not have assurance that the properties for the 49 loans, with unpaid balances totaling more than \$9.5 million, had a continuing and sufficient supply of safe and potable water.

HUD Maintained That Its Existing Policies and Procedures Were Effective

HUD requires lenders to confirm that properties had a continuing and sufficient supply of safe and potable water.¹⁶ HUD Handbook 4000.1 requires appraisers to be familiar with the geographic area¹⁷ and comply with the Uniform Standards of Professional Appraisal Practice, including the competency rule, requiring them to certify that they are capable of performing the appraisal because they had the necessary qualifications and access to all necessary data.¹⁸ The Handbook requires appraisers to notify lenders if a property does not contain a continuing and sufficient supply of safe and potable water.¹⁹ Although none of the public notifications issued by the seven public water systems reviewed stated that the water was not safe and potable, the appraisers should have been aware of the contamination, given their geographic competency requirement, and they should have noted the water quality issue in their appraisals.²⁰ Appendix E lists the requirements and responsibilities for ensuring FHA-insured properties serviced by public water systems have safe water.

HUD officials stated that lenders rely on appraisers to determine whether water testing is required. However, none of the appraisals for the 49 loan files for properties connected to a public water supply, which had issued notices of lead contamination before the appraisal date, mentioned that the notice had been issued or included evidence of water testing.

¹⁴ See footnote 12.

¹⁵ See appendix D for maps identifying the universe of FHA-insured properties serviced by the seven public water systems with unacceptable levels of lead that we reviewed.

¹⁶ See footnote 12.

¹⁷ Section I, paragraph B.1.b.i.(B)

¹⁸ Section II, paragraph A.1.a.iii(B)(6)(a)

¹⁹ Section II, paragraph D.3.c.vii(A)

²⁰ When public water systems do not meet basic requirements, a property may still qualify for an FHA-insured mortgage if it has an individual water purification system that meets all Federal, State, and local standards and additional requirements found in 24 CFR 203.52.

Appraisers did not understand when a water quality test of a property connected to a public water system was required because the existing guidance was not clear. We contacted 13 of the appraisers who appraised properties in our sample to determine the circumstances under which they would test water and whether anyone, including lenders, had instructed them to test water for a property with a public water supply. We found that

- Nine of the appraisers stated that they would request water testing by an expert if they knew there was a problem with the public water supply or if the lender directed them to do so.
- None of the appraisers had ever tested water, nor were they ever directed by a lender to do so, even though the properties in our sample were serviced by public water systems that issued notices of contamination.
- One of the appraisers stated that HUD should require water testing on any property situated in an area known for contaminated water.
- One of the appraisers stated that a water test could be conducted as part of the structural or home inspection.
- One of the appraisers stated that it is assumed that public water is safe.

Lenders cannot follow the requirement to test water if the appraisals did not disclose that the property was serviced by a public water system with unacceptable levels of contaminants. Given that there will continue to be water quality issues throughout the country and inconsistencies in the public notification and emergency declaration processes, the most effective solution may be for FHA to require water testing for all insured properties. According to EPA, testing is the only sure way to determine whether there are harmful quantities of lead in drinking water because a person cannot see, taste, or smell lead dissolved in water. It estimated that a water test by a certified laboratory costs between \$20 and \$100. All of the notices issued by the seven public water systems included instructions for customers to have their water tested. One public water system offered to test the water at no charge, while another made a lead test kit available for purchase for \$10. Managers of a third system advised customers that they could have their water tested by two labs for fees ranging from \$25 to \$75 (see appendix C).

HUD Lacked Controls To Determine Whether Appraisers Complied With Requirements To Notify Lenders So That They Could Ensure FHA-Insured Properties Had Safe Water

HUD did not have controls to ensure that appraisers followed requirements for safe water when submitting appraisals on properties serviced by public water systems that had issued notices of contamination. The appraisers were required to notify the lenders if the property did not contain a continuing and sufficient supply of safe and potable water. On the standard appraisal report forms²¹ the appraisers certified that they have access to public and private data sources for the area in which the property is located and they noted in their reports any adverse conditions observed during the inspection of the property or that they became aware of during their research involved in performing the appraisals. HUD had controls, such as postendorsement technical review and regular monitoring review processes to ensure certain documents were in the files.

²¹ Items 12 and 14 in the appraiser's certification section of Freddie Mac and Fannie Mae appraisal report forms

These controls, however, were not designed to determine whether the appraiser notified the lender of properties in areas serviced by a public water system with unacceptable levels of contaminants. As a result, lenders could not comply with the requirement to confirm that properties had a continuing and sufficient supply of safe and potable water.²²

Conclusion

HUD did not provide sufficient guidance and oversight to ensure that properties approved for mortgage insurance had a continuing and sufficient supply of safe and potable water. This condition occurred because HUD maintained that its existing policies and guidance ensured that lenders and appraisers understood and followed regulations requiring safe water for FHA-insured properties serviced by public water systems when they had excessive lead levels. HUD also lacked controls to determine whether appraisers complied with requirements that they notify lenders of properties in areas serviced by a public water system with unacceptable levels of contaminants so that they could perform required water testing and confirm FHA-insured properties had safe water. The issues identified represent an ongoing safety concern for homeowners and household members. HUD and homeowners may also face an increased risk of loss if property values decrease because of these water quality issues. By improving its guidance and implementing policies and procedures to ensure compliance, HUD would help ensure that properties have a safe and potable water source and thereby put at least \$238.1 million to better use.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

- 1A. Direct the applicable lenders to provide evidence that the properties for the 1,383²³ FHA-insured loans not included in our sample had a safe and potable water source, or that the appraisers had not notified the lender of the water quality issue on their appraisals. If the lenders cannot provide this evidence, HUD should direct them to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD against future loss.
- 1B. Take appropriate administrative action against the lenders or appraisers for any cases in which it finds that they did not take appropriate steps to ensure that properties had a safe and potable water source.
- 1C. Develop and implement additional guidance to advise lenders and appraisers when water testing is required for properties serviced by a public water system which has issued a public notice of water contamination.

²² See footnote 12.

²³ 1,383 = 1,432 (total number of FHA loan files in our universe) – 49 (number of FHA loan files that we reviewed)

- 1D. Develop and implement policies and procedures to ensure that appraisers comply with guidance implemented to resolve recommendation 1C, including penalties for failure to comply, thereby ensuring that at least \$238,090,214²⁴ million is put to better use.
- 1E. Consider requiring water testing for all FHA-insured properties.

²⁴ We determined that the Calumet City, IL, and Providence, RI, public water systems tested the water serving two of the properties in our sample after the loan closing dates. The tests detected no lead contamination. We reduced the amount of funds that could be put to better use by \$251,904, which was the total unpaid balance on the two loans as of April 4, 2017, ($\$238,342,118 - \$251,904 = \$238,090,214$).

Scope and Methodology

We conducted the audit from November 2016 through August 2017 at our offices located in Philadelphia and Pittsburgh, PA. The audit covered the period October 2015 through September 2016, but was expanded to include FHA-insured loans for properties serviced by the seven water systems we reviewed, that closed after January 1, 2015, and before February 28, 2017.

To achieve our audit objective, we reviewed

- relevant background information;
- applicable regulations, HUD handbooks, mortgagee letters, and other guidance; and
- complete loan files provided by the lenders.

We interviewed HUD staff from the Office of Single Family Housing and the Philadelphia Homeownership Center.

We relied in part on computer-processed data in HUD's Single Family Data Warehouse.²⁵ Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found that the data were adequate for our purposes. The testing included matching information obtained from the Single Family Data Warehouse to the loan files provided by the lenders.

USA Today reported in March 2016,²⁶ that nearly 2,000 water systems in all 50 States had elevated levels of lead in tap water samples since 2012. The source of the data was EPA's Safe Drinking Water Information System (SDWIS) that tracks information such as when public water systems exceed maximum contaminant levels.²⁷ The article included a chart with the States, the names of the water systems, and the number of exceedances that occurred. We determined that at least 303 of the systems served a city or municipality, indicating that their customers included homes, which may have FHA-insured mortgages.²⁸ We obtained the population each served from EPA's SDWIS. Of the 303 systems, 73 served populations greater than 3,300, and the remaining 230 systems served a population of no more than 3,300.²⁹ From the 73 systems that

²⁵ The Single Family Data Warehouse contains case-level data on FHA-insured single-family properties and associated loans, claims, and defaults.

²⁶ <https://www.usatoday.com/story/news/2016/03/11/nearly-2000-water-systems-fail-lead-tests/81220466/>

²⁷ We used the data from USA Today because it could be searched more easily. EPA's Safe Drinking Water Information System is not as easy to navigate and requires using several dropdown menus and filters to identify each system, which the USA Today article identified.

²⁸ We believe these 303 water systems likely serve individual homes. The remaining water systems listed had names that referenced schools, businesses, etc.

²⁹ Based on EPA's definition of water system size, a water system that served a population of 3,300 or more was considered medium, large, or very large. If it served a population of 3,300 or less, it was considered very small or small.

served a population of more than 3,300, we selected the 8 systems that had the most exceedances above the EPA action level. From the remaining 230 systems, we selected the 4 systems that had at least 4 exceedances and 4 systems serving the largest populations with at least 3 exceedances. This brought our total to 16 water systems. We performed internet searches on the 16 water systems and found that 7 of them issued public notifications reporting that their water had levels of lead exceeding EPA standards. Since this information was readily available online, we narrowed our scope to these seven public water systems because appraisers would have been able to easily find this information.

We used data as of April 4, 2017, from HUD’s Single Family Data Warehouse, to find FHA-insured loans for properties serviced by the seven water systems. We identified loans for properties that were appraised after the public notification dates and, using auditor judgment based on each water system’s situation, dates we believed the public notification continued to be in effect. We found 1,432 loans with unpaid balances totaling more than \$238.3 million, from which we nonstatistically selected a sample of 49 loans from 34 lenders. The chart below provides additional information about the universe and our sample. Appendix D provides maps showing the locations of the properties in the universe.

Location	Public notification date	Total # of loans	Unpaid balance of universe	# of loans sampled	Unpaid balance of sample
Berthoud, CO	6/1/2016	18	\$4,752,412	6	\$1,582,468
Firestone, CO	10/15/2015	6	1,475,479	6	1,475,479
Calumet City, IL	4/20/2015	71	6,934,444	7	590,101
Passaic Valley, NJ	12/19/2016	31	5,988,140	12	2,889,678
Stillwater, NY ³⁰	1/25/2016	10	2,012,025	4	840,872
Sebring, OH	9/19/2016	1	68,022	1	68,022
Providence, RI	June 2007 ³¹	1,295	217,111,596	13	2,088,871
Totals		1,432	238,342,118	49	9,535,491

We contacted the public water systems to determine whether they tested the water at the properties in our sample. We contacted 13 of the 45 appraisers who appraised properties in our sample to determine the circumstances under which they would test water. We selected the appraiser for the Sebring, OH, loan file. We randomly selected two appraisers from each of the remaining six public water systems.

³⁰ Based on EPA’s definition of water system size, only Stillwater, NY, was considered a small community water system. This represents 14 percent of the 7 public water systems we reviewed and 8 percent of the 49 sample loans we reviewed.

³¹ Providence Water has continuously posted on its website that it has found elevated levels of lead in drinking water in some homes since June 2007. The universe includes loans that closed during 2015.

We reviewed 49 loans to determine whether the files contained documentation to show whether the water quality issue was disclosed or the water was tested. We obtained and reviewed complete loan files to identify information related to the water source, water quality, testing performed on the water, and remediation related to water quality issues. Although this approach did not allow us to make a projection to the entire population of FHA-insured properties nationwide, it was sufficient to achieve our audit objective.

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.

Internal Controls

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

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

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

Relevant Internal Controls

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

- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that the use of resources 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 Deficiency

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

- HUD lacked controls to ensure that appraisers notified lenders of properties in areas serviced by a public water system with unacceptable levels of contaminants so that lenders could comply with the requirement to confirm that the properties had a continuing and sufficient supply of safe and potable water.

Followup on Prior Audits

Office of Single Family Housing, Washington, DC, Oversight of FHA-Insured Loans in Flint, MI; Audit Report 2016-PH-0003; Issued July 29, 2016

The following recommendation from the prior audit is significant within the context of the audit objective for this audit and was still open at the time of this report:

1F. Improve its controls to ensure that it does not insure additional loans in Flint, MI, for properties that do not have a safe and potable water source. These controls could include updating its endorsement or monitoring processes until the water contamination issue has been resolved in Flint. HUD agreed to review controls in place as a result of existing policy to assess the adequacy of its processes for ensuring compliance with FHA policy relative to the minimum property standards for a safe and potable water supply. HUD agreed to issue a memorandum by December 20, 2017, articulating the results of its review of the relevant controls and its plan for implementing any changes to existing controls.

Appendixes

Appendix A

Schedule of Funds To Be Put to Better Use

Recommendation number	Funds to be put to better use 1/
1D	\$238,090,214

- 1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, if HUD implements our recommendations, it will stop endorsing loans for properties with known water issues and, instead, will endorse loans for properties that have a safe and potable water source at the time the loans close.


Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

SEP 12 2017

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

MEMORANDUM FOR: David E. Kasperowicz, Regional Inspector General for Audit
Philadelphia Region, 3AGA

FROM: *Gisela G. Kojet*
Gisela G. Kojet, Deputy Assistant Secretary for Single Family
Housing, HU

SUBJECT: Discussion and Comments on Draft Audit:
HUD Did Not Provide Sufficient Guidance and Oversight to
Ensure That FHA-Insured Properties Nationwide Had Safe Water

OIG Audit Report 2017-PH-XXXX
Issue Date: August, 2017

The Office of Inspector General (OIG) performed a review of the U.S. Department of Housing and Urban Development's (HUD) oversight of safe water requirements for Federal Housing Administration (FHA)-insured loans nationwide. The objective of the audit was to determine whether HUD provided sufficient guidance and oversight to ensure that properties approved for mortgage insurance had a continuing and sufficient supply of safe and potable water. The OIG reviewed 49 loans files for properties connected to a public water supply for which a notice that it had lead contamination was issued to the public. The OIG found that none of the loan files disclosed the contamination or contained evidence of water testing.

As noted in the draft OIG Report, HUD Secretary Dr. Ben Carson has a commitment to creating healthy homes. The Office of Single Family Housing (Single Family) also recognizes the importance of this matter. FHA's regulations at 24 CFR § 200.926d set minimum construction requirements for FHA mortgage insurance that include, among other criteria, that the home "shall be provided with a continuing and sufficient supply of safe water under adequate pressure and of appropriate quality for all household uses." Single Family also recognizes that its policies and guidance to the lending and appraisal community on this topic merit review. Accordingly, Single Family has begun a review of its policies and guidebooks, and pending the completion of this review, Single Family is prepared to create a plan to improve its guidance to industry partners.

Response to OIG Proposed Findings and Recommendations

1) Develop and Implement New Guidance

Single Family agrees with OIG's recommendations concerning the need to develop and implement additional guidance regarding safe water requirements. Single Family will review its current guidelines and consult with appropriate government authorities to seek to develop policies to ensure lenders and appraisers have clear and consistent guidance for determining when water testing

www.hud.gov espanol.hud.gov

Comment 1

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 2

should be required for properties serviced by a public water system, which has issued a public notice of water contamination. Additionally, Single Family intends to consult with the United States Environmental Protection Agency (EPA) as well as HUD's Office of Lead Hazard Control and Healthy Homes. Single Family would commend to the OIG's attention the collaboration already underway between the EPA and HUD on lead safety. This effort has produced, for example, the June 2017 publication issued jointly by EPA, HUD and Consumer Product Safety Commission titled, "Protect Your Family from Lead in Your Home," which provides consumer education on lead hazards from a variety of sources including water. The publication is available through HUD's website, at www.hud.gov/healthyhomes/enforcement/disclosure, with the file specifically at www.epa.gov/sites/production/files/2017-06/documents/pyf_color_landscape_format_2017_508.pdf.

Comment 3

In its review, Single Family will seek to leverage the current structure of determining compliance with minimum property requirements which utilizes appraisers with local market knowledge as the front line on site reviewer of properties, combined with the lenders' review of the appraisal and any other information that is consistently available and executable on a national scale. In this effort, Single Family will seek to balance its primary missions of providing access to affordable mortgage credit while protecting the Mutual Mortgage Insurance Fund and the need to promote safe housing.

Comment 4

Single Family will also consider the technical aspects and programmatic impact of the recommendation to require water testing for all properties. For example, Single Family is aware that the EPA does not have criteria for assessing the lead in drinking water at individual taps or residences, only a water-system-wide standard. In determining whether to require such mandatory testing, Single Family will consider the impact of the cost of such testing, combined with the ability for the market to execute such a requirement on a consistent basis nationwide.

Comment 5

2) Administrative Actions

Regarding the recommended administrative actions, Single Family has reservations due to its current policy shortfalls. HUD Handbook 4000.1 states that the appraiser is the on-site representative for the lender to determine if a property meets FHA's minimum requirements. This includes a continuing and sufficient supply of safe and potable water. However, as identified in the audit report, existing Single Family policy does not include sufficient, specific guidance for appraisers or lenders to determine when testing should be required for public water supplies. Additionally, FHA has no direct evidence that any appraiser or lender had knowledge that the water at a specific property was not potable at origination. Absent a specific standard for requiring testing or any evidence of actual knowledge of unsafe water in a specific property, to take any administrative action would impermissibly impose additional post hoc requirements for lenders to provide evidence of water testing or remediation that is unlikely to withstand legal scrutiny. Single Family has agreed to review and revise its policies to provide needed clarity that strikes the appropriate balance between safety and mission. Imposing post hoc requirements on a subset of FHA lenders runs the risk that other lenders or appraisers will infer alternative policy requirements that are not consistent with the intended policy direction of Single Family and self-impose requirements to conduct unnecessary water testing simply to avoid future litigation risk. Due to the

Comment 6

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 7

potential unintended consequences, Single Family does not believe the imposition of sanctions at this time presents a viable alternative.

Because Single Family considers water safety to be an important concern, while revised policies are under development, Single Family will leverage its strong training program for both lenders and appraisers to ensure that the topic of safe and potable water is given appropriate attention in FHA related lender and appraiser training.

3) Conclusion

Single Family acknowledges the policy and guidance deficiencies that were brought to light in the audit and is in full agreement that a review of the existing policies is needed. Single Family however, respectfully requests the OIG to reevaluate Recommendations 1A and 1B and to provide Single Family with the opportunity to complete a comprehensive review of its current policy and inform the lending and appraisal communities of its commitment to safe and potable water.

OIG Evaluation of Auditee Comments

- Comment 1 HUD agreed with our recommendations concerning the need to develop and implement additional guidance regarding safe water requirements. It will review its current guidelines and consult with appropriate government authorities to seek to develop polices to ensure that lenders and appraisers have clear and consistent guidance for determining when water testing should be required for properties serviced by a public water system which has issued a notice of contamination. These planned actions meet the intent of the recommendations. However, to reach a management decision under HUD's Audits Management System, HUD needs to identify the evidence it will provide to show that the planned actions have been implemented as well as target dates for completing the actions.
- Comment 2 HUD stated that a June 2017 publication it issued jointly in collaboration with EPA and Consumer Product Safety Commission titled, "Protect Your Family from Lead in Your Home," provides consumer education on lead hazards from a variety of sources including water. Although this publication is useful for homeowners, it does not address our finding that HUD did not provide sufficient guidance and oversight to ensure that properties it approved for mortgage insurance had a continuing and sufficient supply of safe and potable water. According to the EPA, testing is the only way to determine if water has harmful quantities of lead. Similar to the notices of contamination issued by public water systems addressed in appendix C of this audit report, the publication informs consumers to contact the local water company about testing the water, and that some offer free testing. As recommended in the audit report, HUD needs to develop and implement additional guidance to advise lenders and appraisers when water testing is required for properties serviced by a public water system which has issued a public notice of water contamination.
- Comment 3 HUD stated it will use appraisers with local market knowledge and lenders' review of appraisals and other information that is consistently available and executable on a national scale in its review. It seeks to balance its primary missions of providing access to affordable mortgage credit while protecting the insurance fund and the need to promote safe housing. We acknowledge that HUD has multiple important goals to balance. However, as stated in the audit report, lead is a toxic metal harmful to human health, even at low exposure and EPA and the Centers for Disease Control and Prevention agree that there is no known safe level of lead in a child's blood. HUD Secretary Dr. Carson has publicly made known his commitment to creating healthy homes. The ongoing safety of homeowners and household members is a priority. It is for this reason that we recommended that HUD consider requiring water testing of all FHA-insured properties.

Comment 4 HUD stated it will also consider the technical aspects and programmatic impact of our recommendation to require water testing for all properties. It also stated that it will consider the cost and the ability for the market to execute testing on a consistent basis nationwide. These planned actions meet the intent of the recommendation. However, to reach a management decision under HUD's Audits Management System, HUD needs to identify the evidence it will provide to show that it completed the planned actions as well as target dates for completing the actions.

Comment 5 HUD stated that because its handbook does not include sufficient, specific guidance for appraisers or lenders to determine when water supplied by public water systems should be tested, it hesitates to impose administrative actions as we had recommended. Additionally, it stated that it has no direct evidence that any appraiser or lender had knowledge that the water at a specific property was not potable at the time the loan originated.

As stated in the audit report, appraisers were required to notify the lenders if the property did not contain a continuing and sufficient supply of safe and potable water. On the standard appraisal report forms the appraisers certified that they have access to public and private data sources for the area in which the property is located and they noted in their reports any adverse conditions observed during the inspection of the property or that they became aware of during their research involved in performing the appraisals. We reviewed 49 of 1,432 loan files for properties serviced by 7 public water systems for which a notice that it had lead contamination was issued to the public to determine whether the files contained information about declared contamination and evidence that the water was safe. None of the 49 files contained information regarding the public notices that had been issued, nor did they contain evidence of water testing. All 49 loans were appraised and closed after the date of the public notification by the public water system. We performed internet searches and found the public notifications. Since this information was readily available online, the appraisers should have been able to easily find this information as well. The appraisers should have disclosed this information on their appraisals.

In the resolution of the recommendations from our audit report regarding safe water for FHA-insured properties located in Flint, MI, HUD agreed to take appropriate administrative sanctions against appraisers if they did not take appropriate steps to ensure that properties had a safe and potable water source, meaning that the appraisal should rightly have indicated a lack of safe and potable water supply but did not. In February 2017, HUD sent Notices of Appraisal Deficiencies and Remedial Education to 23 appraisers who appraised properties serviced by the City of Flint's public water service after the Genesee County Health Department issued a public health emergency declaration. HUD advised the appraisers that they were being sanctioned because they failed to comment or alert the lender to the possibility of a contaminated water supply in their

appraisals. HUD required the appraisers to receive 7 hours of training and provide evidence of successful completion of the training. If HUD finds that a lender reasonably relied upon a determination of potable water made by the appraiser, it may find the lender to be compliant with FHA guidance even if the appraiser's determination was found to be noncompliant. HUD stated that the determination of whether a lender was in compliance with FHA property requirements at the time loans closed always relies heavily on whether there was evidence that an appraiser noted a failure on the appraisal and subsequently whether the lender resolved the noncompliance noted by the appraiser. We acknowledge that the water quality issues related to the seven water systems that we reviewed were not of the same magnitude as the public health emergency declared for the water in Flint, however, it appears that the appraisers did not perform simple research to satisfy the requirement that properties have safe and potable water.

Comment 6 HUD stated that without a specific standard for requiring testing or any evidence of actual knowledge of unsafe water on a specific property, taking administrative action would impose prohibited additional after-the-fact requirements for lenders to provide evidence of water testing or remediation that is unlikely to withstand legal scrutiny. Imposing after-the-fact requirements on a subset of FHA lenders runs the risk that other lenders or appraisers will infer alternative policy requirements that are not consistent with the intended policy direction and self-impose requirements to conduct unnecessary water testing simply to avoid future litigation risk. Therefore, due to potential unintended consequences, it does not believe that imposing sanctions is a viable alternative at this time.

We disagree. As shown in the audit report, appraisers and lenders are responsible for ensuring that insured properties have safe and potable water sources. In response to the water contamination crisis in Flint, MI, HUD issued a questions and answers document on February 8, 2016, to remind lenders and other stakeholders involved with FHA transactions that to be eligible for FHA insurance, a property must meet FHA's property acceptability criteria. The document states that if the lender is aware that a property is located in an area serviced by a public water system with unacceptable levels of contaminants, a water test is required.

We are not recommending that HUD impose additional after-the-fact requirements on lenders. We are recommending that HUD determine whether appraisers and lenders complied with their requirements. In recommendation 1A, we recommend, for the 1,383 loans we did not review, that the lenders provide either evidence that the insured properties had a safe and potable water source, or evidence that the appraisers had not notified them of the water quality issue on their appraisals. By doing this, HUD would obtain direct evidence that an appraiser or lender had knowledge that the water at a specific property was not potable at the time the loan originated. Based on our sample, it is likely that few,

if any, of the appraisers noted the water quality issue on their appraisals. If that was not the case, then we are recommending that HUD direct the lenders to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD against future loss because they did not resolve water quality issues noted on appraisals. This is consistent with the action HUD agreed to take to resolve the recommendations from our audit report regarding safe water for FHA-insured properties located in Flint.

Comment 7 HUD requested that we reevaluate recommendations 1A and 1B. We believe that our recommendations are reasonable based on the finding. See comments 5 and 6.

Appendix C

Notices of Lead Contamination in Seven Public Water Systems

Seq. no.	Public water system	Method of communication to customers	Reason for notice	Instruction provided to customers
1	Town of Berthoud, CO	Notification letter mailed to customers; community newsletter posted on town's website; press release	Testing exceeded EPA action level ³²	Press release identified eight steps customers could take to reduce exposure to lead in their water.
2	Town of Firestone, CO	Notification letter mailed to customers and posted to town's website	Testing exceeded EPA action level	Notification letter identified seven steps customers could take to reduce exposure to lead in their water.
3	Calumet City, IL	Notification letter mailed to customers and posted to city's website	Testing exceeded EPA action level	Notification letter advised customers that they could have their water tested, at their expense, by two labs. One lab charged \$25 for the test, and the other charged \$45. Shipping cost, if needed, was \$15 one way.
4	Sebring Village, OH	Notification letter posted to village's website	Testing exceeded EPA action level	Notification letter identified eight steps customers could take to reduce exposure to lead in their water. The public water system will test water for customers who request it, free of charge.

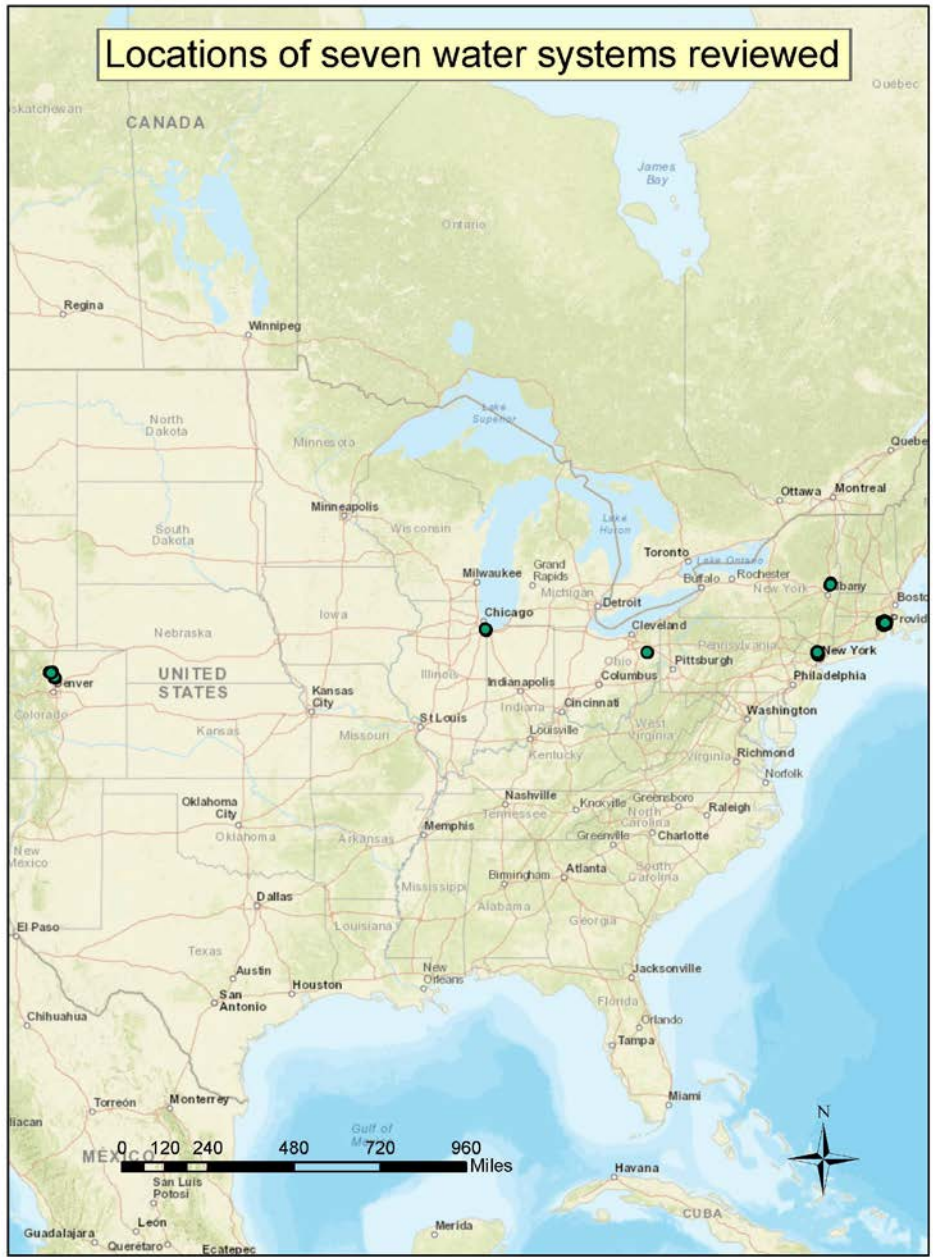
³² The EPA action level determines when public notification is required. The Public Notification Rule of the Safe Drinking Water Act requires water systems to notify consumers of contamination if lead levels exceed 15 ppb in more than 10 percent of samples, known as "action levels."

Seq. no.	Public water system	Method of communication to customers	Reason for notice	Instruction provided to customers
5	Stillwater Village, NY	Notification letter posted to village's website	Testing exceeded EPA action level	Notification letter identified five steps customers could take to reduce exposure to lead in their water.
6	Passaic Valley, NJ	Notification letter mailed to customers and posted to Passaic Valley Water Commission's website	Testing exceeded EPA action level	Notification letter identified eight steps customers could take to reduce exposure to lead in their water.
7	Providence, RI	Notification letter mailed to customers and posted to Providence Water's website	Testing exceeded EPA action level	Notification letter identified seven steps customers could take to ensure that their water was as lead-free as possible and advised that for a \$10 fee, the customer could purchase a lead test kit. If the lead levels are high for the first sample, the public water system will pay for a second test.

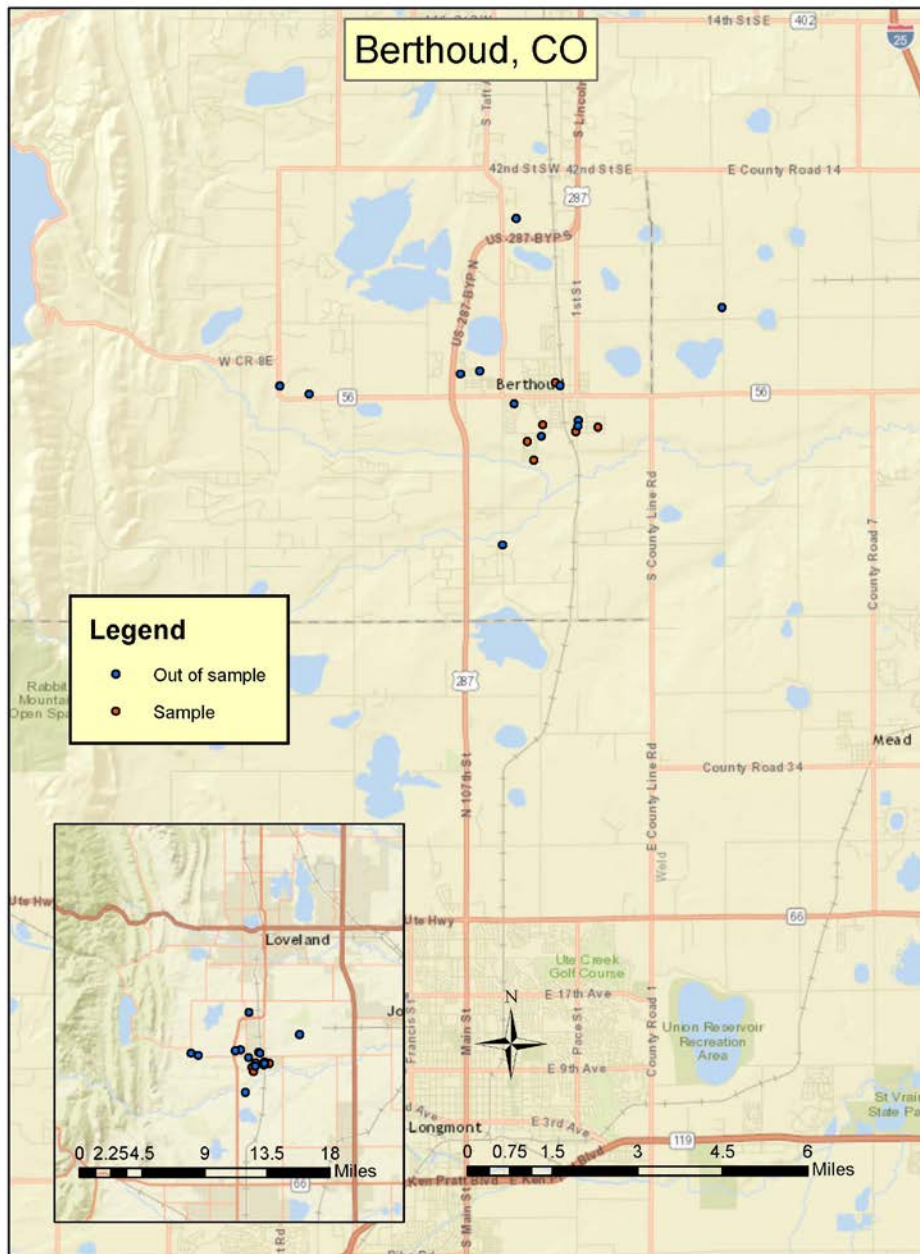
Appendix D

Maps of FHA-Insured Properties Serviced by the Seven Public Water Systems That Issued Public Notices of Unacceptable Lead Levels

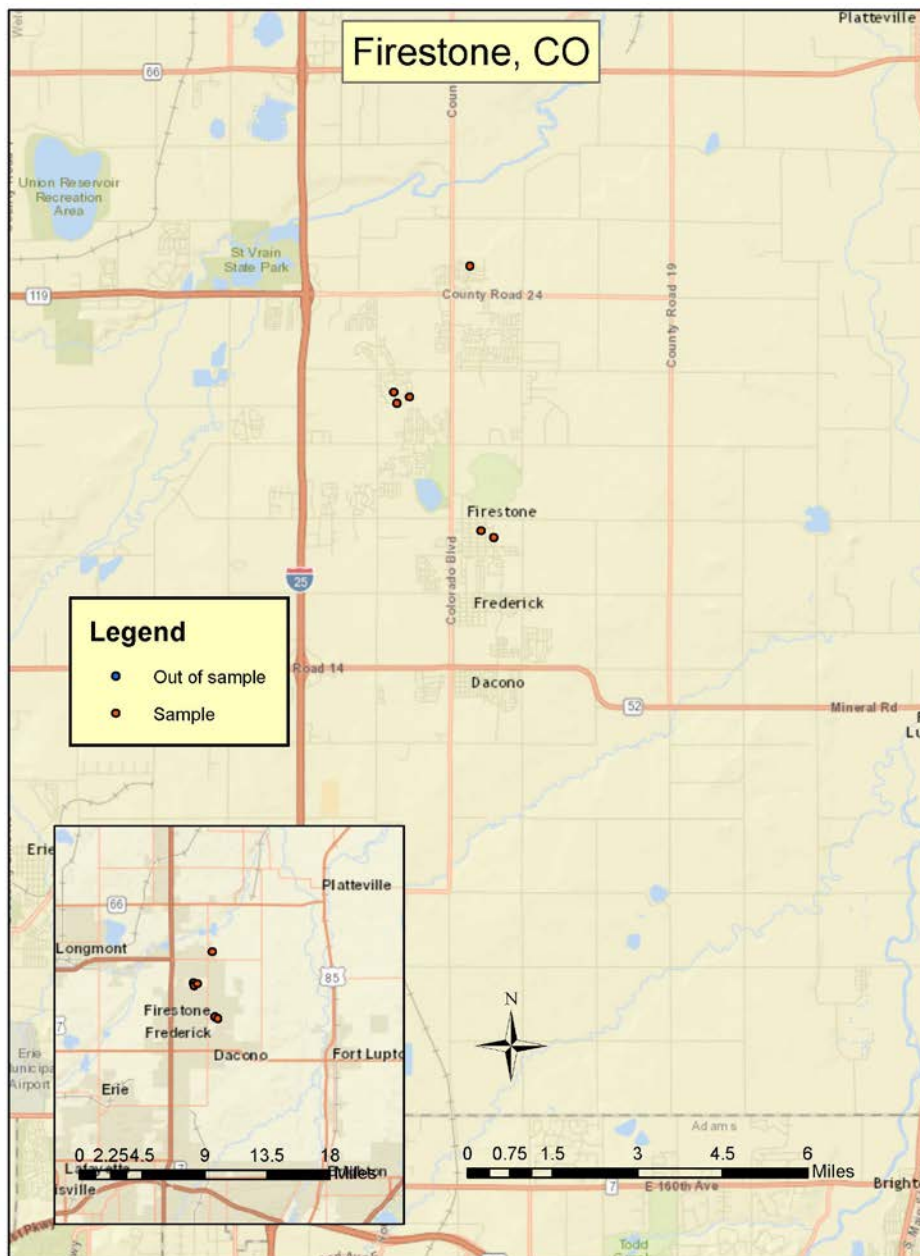
The following maps detail the universe of FHA-insured properties serviced by the seven public water systems with unacceptable levels of lead that we reviewed. We found 1,432 loans for properties that were appraised and the loans closed after each water system's public notification date, with unpaid balances totaling more than \$238.3 million. The unpaid balances of the loans were as of April 4, 2017, the date on which we pulled data from HUD's Single Family Data Warehouse. Each map details the location of the properties and the total number of loans and their total unpaid loan balance for each area.



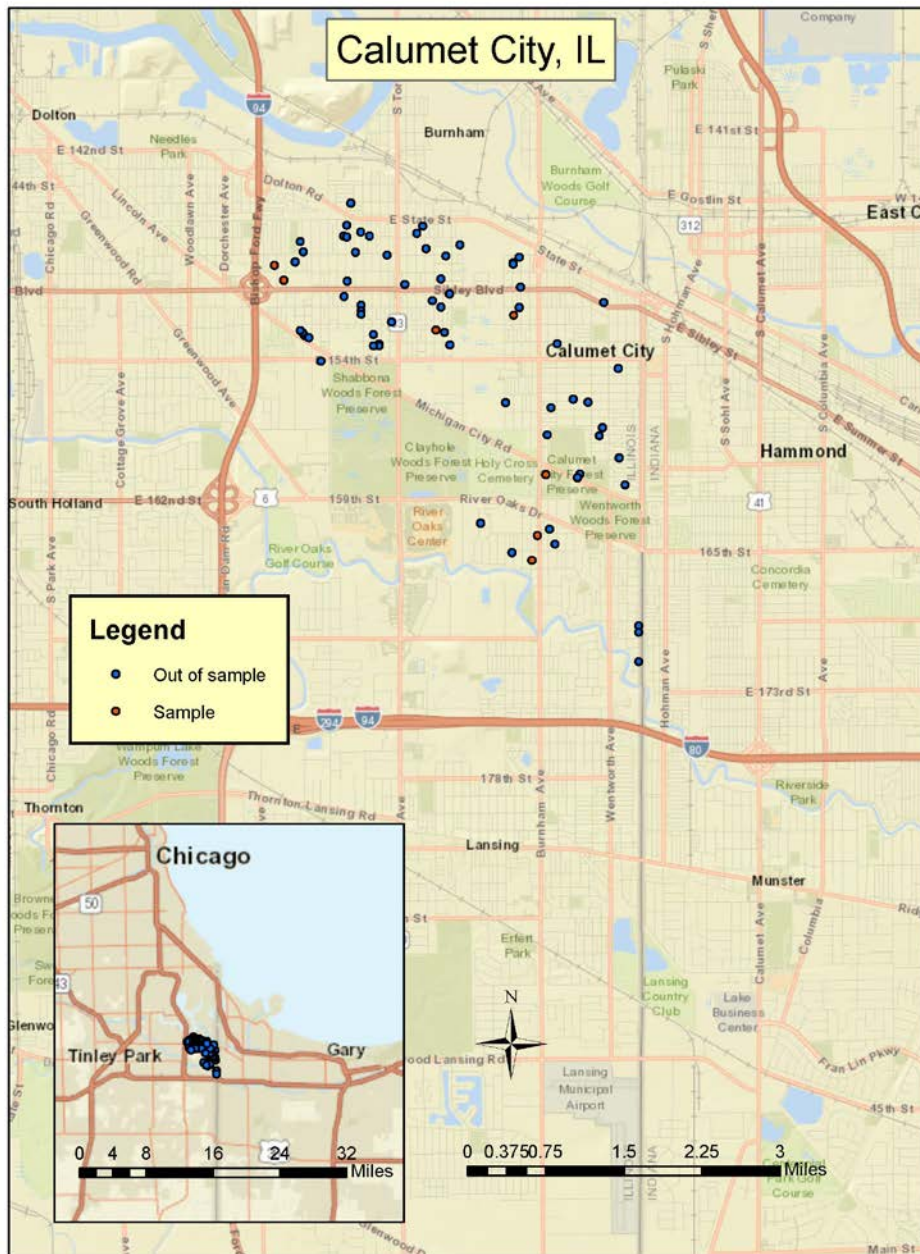
1,432 loans with unpaid balances totaling more than \$238.3 million



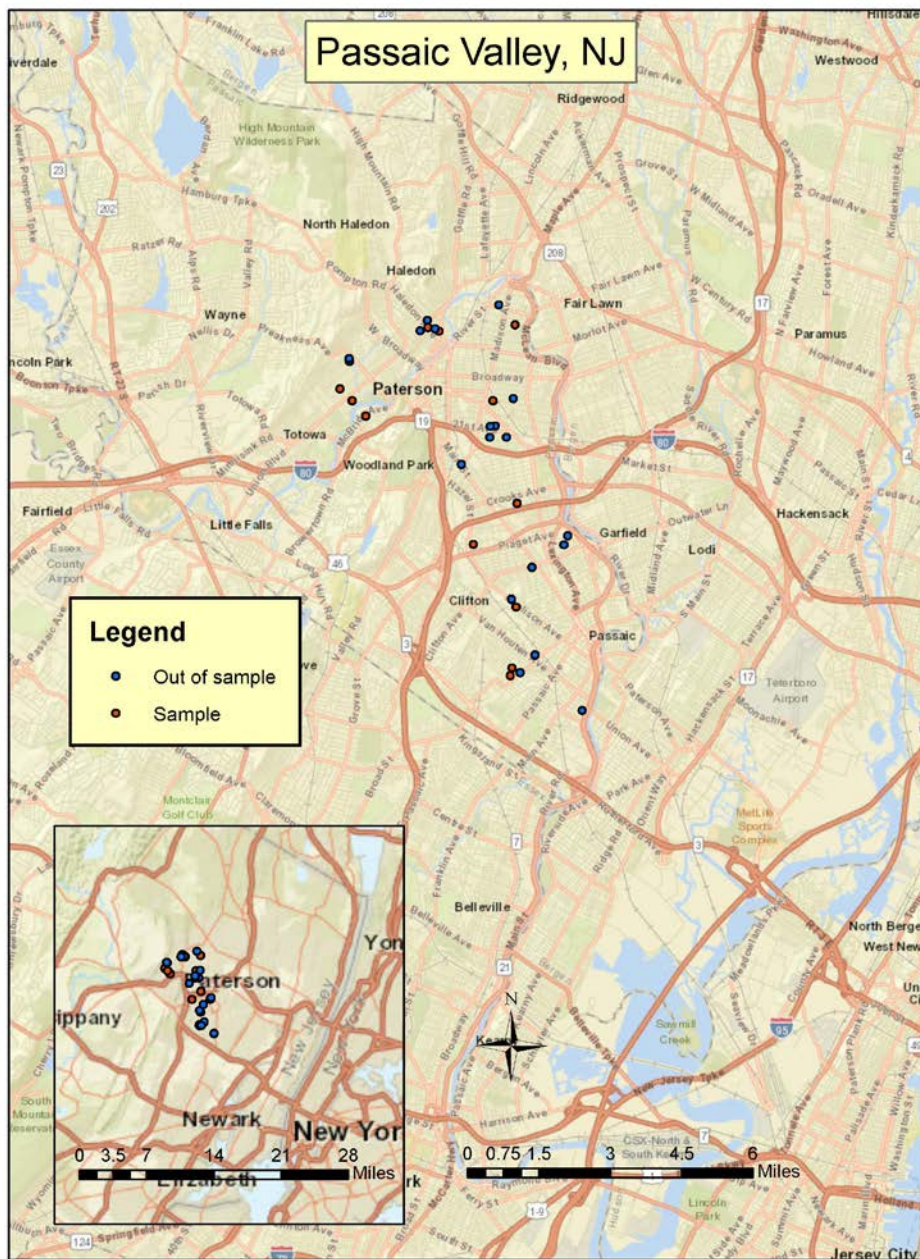
18 loans with unpaid balances totaling \$4.8 million



Six loans with unpaid balances totaling \$1.5 million



71 loans with unpaid balances totaling \$6.9 million



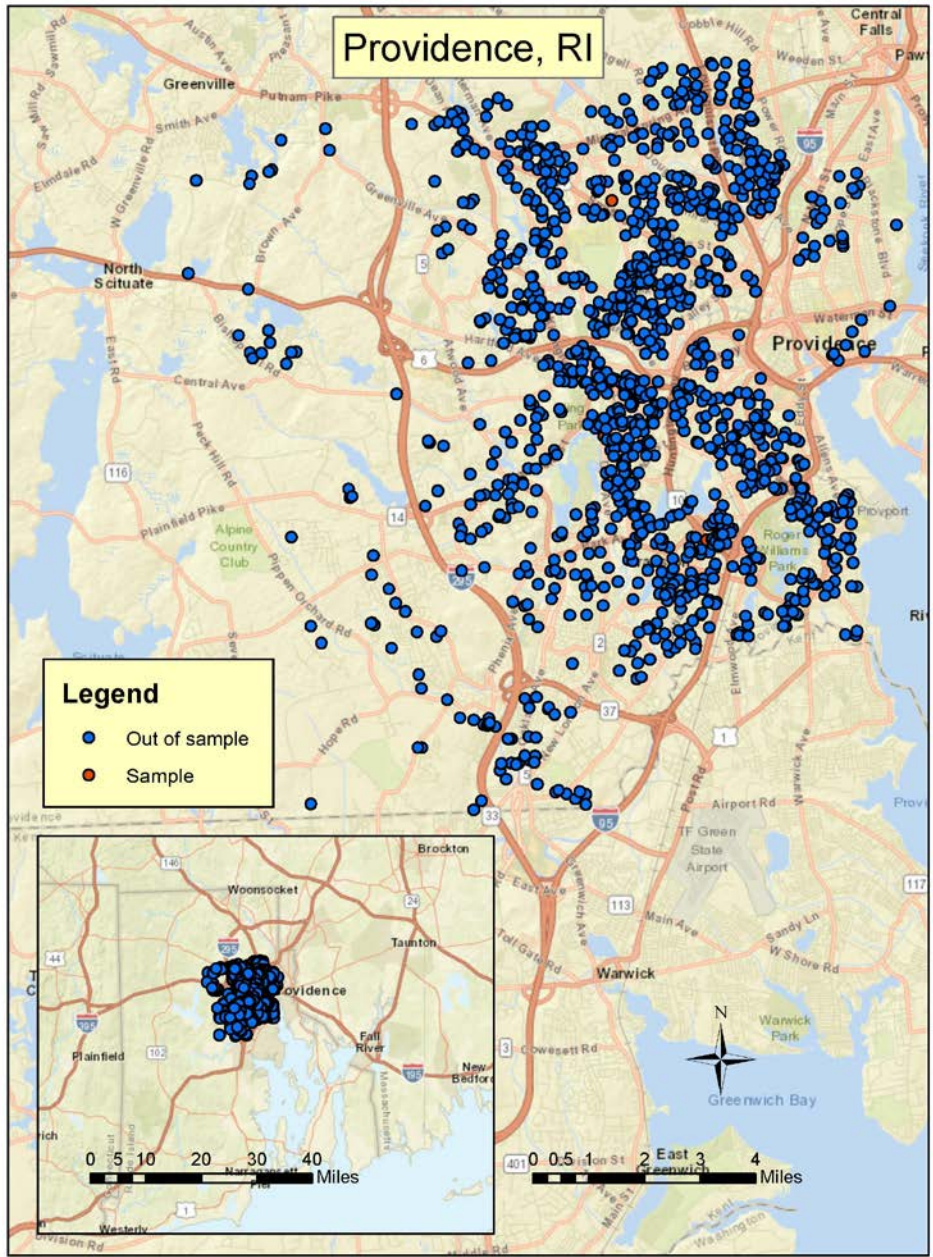
31 loans with unpaid balances totaling \$6.0 million



10 loans with unpaid balances totaling \$2.0 million



One loan with an unpaid balance totaling \$68,022



1,295 loans with unpaid balances totaling \$217.1 million

Appendix E

Responsibilities for Ensuring That FHA-Insured Properties Serviced by Public Water Systems Have Safe Water

Criteria or guidance	Requirement	Responsibility
EPA Safe Drinking Water Act Public Notification Rule	Notify consumers of action level contamination.	Public water suppliers
HUD Single Family Housing Policy Handbook 4000.1, section II, paragraph A.3.a.ii(F), and 24 CFR 200.926d(f)	Confirm that each living unit contains a continuing and sufficient supply of safe and potable water.	Lenders
Single Family Housing Policy Handbook 4000.1, section II, paragraph A.3.a.ii(J)	Confirm that the property is free of all known environmental and safety hazards and adverse conditions that may affect the health and safety of the occupants.	Lenders
HUD website FAQ: “Appraisal/Property Analysis/Property Eligibility” Topic #57345-8682. Created: February 8, 2016	Test water in properties serviced by a public water system with unacceptable levels of contaminants; specifically, if quality does not meet EPA standards.	Lenders
24 CFR 203.52	A property may still qualify for an FHA-insured mortgage when the public water system does not meet basic requirements if it has an individual water purification system that meets all Federal, State, and local standards and additional requirements, such as setting up an escrow account to be funded by the borrower, to ensure that the individual system is maintained.	Lenders
HUD Single Family Housing Policy Handbook 4000.1, section II, paragraph D.3.c.vii(A)	Notify the lender if living unit does not contain a continuing and sufficient supply of safe and potable water.	Appraisers

Criteria or guidance	Requirement	Responsibility
HUD Single Family Housing Policy Handbook 4000.1, section I, paragraph B.1.b.i.(A-C)	Appraisers must be on the FHA Appraiser Roster, knowledgeable in the market where the assignment is located, and a state-certified residential or state-certified general appraiser.	Appraisers
HUD Single Family Housing Policy Handbook 4000.1, section II, paragraph A.1.a.iii(B)(6)(a)	Appraisers must comply with the Uniform Standards of Professional Practice, including the competency rule, when conducting appraisals for properties intended as security for FHA-insured financing.	Appraisers
2016 – 17 Uniform Standards of Professional Appraisal Practice	Competency rule requires appraisers to certify that they are capable of performing the appraisal because they have the necessary qualifications and access to all necessary data.	Appraisers
Appraisal Report: Appraiser’s Certification section, items 12 and 14	The appraiser certifies and agrees that he or she (1) is aware of, and has access to, the necessary and appropriate public and private data sources for the area in which the property is located and (2) reports any adverse conditions observed during the property inspections or that they became aware of during their research.	Appraisers