Issue Date
January 14, 2008

Audit Report Number
2008-KC-0001

TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

//signed//
FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: HUD's Quality Assurance Division Did Not Always Resolve Materially Deficient or Potentially Fraudulent Loans Consistently

HIGHLIGHTS

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) Quality Assurance Division because the results of some previous Office of Inspector General (OIG) audits indicated that the Quality Assurance Division might not have consistently followed its requirements.

Our objective was to determine whether HUD's Quality Assurance Division consistently required Federal Housing Administration (FHA)-approved lenders to indemnify loans with similar material deficiencies and whether it appropriately handled potentially fraudulent loans.

What We Found

HUD's Quality Assurance Division did not always resolve materially deficient or potentially fraudulent loans consistently. As a result, HUD increased its risk of treating lenders differently in similar situations. In addition, OIG did not have the opportunity to pursue actions against parties responsible for fraudulent loans, and the FHA insurance fund incurred unnecessary losses and remains at risk for additional losses on fraudulent loans.

What We Recommend

We recommend that HUD develop and implement effective policies and procedures to ensure uniform resolutions to loan underwriting deficiencies and handling potentially fraudulent loans. We also recommend that HUD coordinate with OIG to reevaluate the agreement between HUD and OIG regarding referring potentially fraudulent loans to OIG. Further, we recommend that HUD require lenders to indemnify 16 insured loans that contained evidence of fraud.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the report to HUD on November 19, 2007, and requested a response by December 14, 2007. HUD provided written comments on December 19, 2007.

HUD disagreed with our conclusion that it needed to formalize instructions to Quality Assurance Division staff responsible for lender oversight. However, as we recommended, HUD recently met with OIG to reevaluate and refine the referral process for potentially fraudulent loans. HUD also agreed to review and consider indemnification for 16 potentially fraudulent loans.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

TABLE OF CONTENTS

Background and Objectives 4

Results of Audit

Finding: HUD's Quality Assurance Division Did Not Always Resolve Materially Deficient or Potentially Fraudulent Loans Consistently 5

Scope and Methodology 11

Internal Controls 13

Appendixes

A. Schedule of Questioned Costs and Funds to Be Put to Better Use 14

B. Auditee Comments and OIG's Evaluation 15

C. HUD Requirements For Referring and Indemnifying Fraudulent Loans 19

D. Potentially Fraudulent Loans for Which HUD Did Not Follow Requirements 20

E. Potentially Fraudulent Loans without Indemnifications 21

BACKGROUND AND OBJECTIVES

As part of the U.S. Department of Housing and Urban Development (HUD), the Federal Housing Administration (FHA) provides mortgage insurance on loans made by approved lenders throughout the United States and its territories. FHA mortgage insurance provides lenders with protection against losses as the result of homeowners' defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default. Loans must meet established FHA requirements to qualify for insurance. FHA currently has 4.8 million insured single-family mortgages.

HUD's Office of Single Family Housing is responsible for the overall management and administration of FHA single-family mortgage insurance programs. The mission of the Office of Single Family Housing is to expand and maintain affordable homeownership opportunities for those that are not served or are underserved by the private market and to provide a consistent, stabilizing force in the home financing market.

Within the Office of Single Family Housing, the Office of Lender Activities and Program Compliance, Quality Assurance Division, is responsible for monitoring FHA-approved lenders. In performing its monitoring duties, the Quality Assurance Division is to assess lender performance, internal controls, and compliance with HUD origination and servicing requirements, largely through on-site reviews of lender practices, but also through off-site evaluations and analyses.

The Quality Assurance Division performs lender oversight functions at HUD headquarters in Washington, DC, and at the four homeownership centers located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California. In addition to overseeing lenders, the headquarters staff is responsible for overseeing the work of the Quality Assurance Division staff in the four homeownership centers. This internal quality control function is intended to ensure that

- Monitoring reviews of lenders are conducted in a consistent manner and of the same quality throughout each homeownership center;
- Monitoring review letters identifying loan deficiencies noted during lender reviews are consistent with regard to form, content, policies, findings, and outcomes across each homeownership center and within branches of regional and national lenders; and
- Data in HUD's lender review tracking database are accurate.

Our objective was to determine whether HUD's Quality Assurance Division consistently required FHA-approved lenders to indemnify loans with similar material deficiencies and whether it appropriately handled potentially fraudulent loans.

RESULTS OF AUDIT

Finding: HUD’s Quality Assurance Division Did Not Always Resolve Materially Deficient or Potentially Fraudulent Loans Consistently

HUD’s Quality Assurance Division did not always resolve materially deficient or potentially fraudulent loans consistently. The inconsistencies happened because the Quality Assurance Division did not establish organized, formal instructions for its managers in the homeownership centers to follow when making decisions on pursuing indemnifications from lenders for material underwriting deficiencies. Additionally, for various reasons, the local Quality Assurance Division staff decided not to follow requirements for resolving potentially fraudulent loans. As a result, HUD increased its risk of treating lenders differently in similar situations and of causing unnecessary losses to the Insurance Fund.

Loan Indemnifications on Materially Deficient Loans Not Consistently Required

HUD’s Quality Assurance Division units in the four homeownership centers were generally consistent in resolving material underwriting deficiencies but sometimes had different approaches for resolving the deficiencies. The Quality Assurance Division guide, effective in 2001, states that FHA program requirements are essentially uniform throughout the country and the Quality Assurance Division is to uniformly apply lender monitoring and review procedures, findings, and actions.

We analyzed more than 800 loan deficiencies identified by the homeownership centers while conducting 48 lender monitoring reviews from December 2003 through September 2006. The homeownership centers identified 235 of the 800 deficiencies as material because these deficiencies presented a significant risk of loss to the FHA insurance fund. The 235 material deficiencies represented 190 FHA loans.

The Quality Assurance Division units in the homeownership center sometimes took different approaches when resolving loan deficiencies. As an example, the homeownership centers differed regarding the materiality of loan underwriting deficiencies that warranted indemnifications from lenders. For example,

- The Philadelphia homeownership center obtained indemnifications on FHA case numbers 061-2532902, 374-3814858, and 374-3842967 when the borrower's and/or coborrower's verifications of employment were either missing from the loan file submitted to HUD or illegible. Conversely, the Santa Ana homeownership center did not pursue indemnification of FHA case number 332-4306607 in which the lender could not provide evidence that it had verified the borrower's current employment. According to HUD's letter to the lender, the homeownership center accepted two prior year Internal Revenue Service W-2 forms (showing past employment) in place of a current verification of employment. A quality assurance manager told us that she did not consider a missing verification of current employment a material deficiency if the lender submitted other employment documentation.

Another difference was that the Santa Ana homeownership center did not pursue indemnifications if the loan had an acceptable payment history and was currently performing. A quality assurance manager told us that if the loan was performing, the loan deficiencies were probably not relevant to the borrower's ability to pay. For example,

- In FHA case number 561-7935351, the borrower needed nearly $3,000 to close the loan, but the lender did not verify the borrower's assets. The lender agreed that it did not follow FHA requirements in underwriting the loan. However, the homeownership center closed the review with a letter to the lender stating that the loan had remained current since endorsement and, therefore, HUD did not require the lender to indemnify the loan.

An additional difference was that the Atlanta and Santa Ana homeownership centers did not pursue indemnifications when lenders promised to do a better job of following FHA requirements in the future. For example,

- In nine cases, the lenders were not able to provide additional documentation to resolve material loan deficiencies but promised to provide training to staff to prevent the same problem in the future.

FHA case number
201-3305349
201-3357107
201-3384160
201-3386887
201-3402921
332-4233611
332-4391555
561-9209251
569-0615746

According to correspondence with the lender, the homeownership centers closed the reviews without requiring indemnifications, based on the lenders' commitments to provide additional FHA underwriting guidance to their staff. However, lender correspondence from the Philadelphia and Denver homeownership centers showed that these units required lenders to indemnify deficient loans even when the lenders promised to improve their underwriting on future loans.

Potentially Fraudulent Loans Not Consistently Referred or Indemnified

Quality Assurance Division staff in the homeownership centers did not consistently refer potentially fraudulent loans to OIG or require indemnifications from the lenders when appropriate. Two homeownership centers referred fraud but did not obtain indemnification agreements. One homeownership center obtained indemnification agreements for fraudulent loans but did not refer them to OIG. The other homeownership center did not refer fraud, and it did not obtain indemnification agreements.

HUD has instituted multiple instructions that require its staff to refer evidence of fraudulent loans to OIG. HUD Handbook 4060.1, the Quality Assurance Division guide, and a July 2003 memorandum of understanding between HUD and OIG require HUD staff to refer potentially fraudulent loans to OIG. The Office of Single Family Housing also issued a November 2005 policy statement outlining when HUD should require lenders to indemnify materially deficient loans, including loans that contain evidence of fraud. Appendix C provides details of the HUD instructions.

None of the HUD guidance or agreements limit the Quality Assurance Division's referral responsibility based on severity of fraud, whether the lender was a party to the fraud, or whether OIG may pursue cases against parties committing the fraud.

We noted 34 potentially fraudulent loans that Quality Assurance Division staff did not properly process: 32 loans reported to HUD by lenders and two loans identified by HUD staff during their monitoring reviews. Of the 34 loans, the homeownership centers did not refer 25 loans to OIG and did not obtain indemnifications on 16 loans.

- The Philadelphia homeownership center referred all five potentially fraudulent loans identified to OIG but did not require indemnification from the lenders on any of the loans.

- The Denver homeownership center referred all four potentially fraudulent loans identified to OIG but did not require indemnification from the lenders on any of the loans.

- The Atlanta homeownership center did not refer any of the three potentially fraudulent loans identified to OIG, nor did it require indemnification from the lenders.

- The Santa Ana homeownership center did not refer any of the 22 potentially fraudulent loans identified to OIG but required indemnification from the lenders on 13 of the loans.

Appendix D provides details on the 34 loans.

Adequate Indemnification Instructions Not Provided

HUD did not establish organized, formal instructions for homeownership center Quality Assurance Division managers to follow when making decisions on pursuing loan indemnifications on loans with material underwriting deficiencies. The Quality Assurance Division guide does not provide standards that would better ensure consistent decisions among the homeownership centers.

In addition, HUD headquarters provided homeownership center managers informal guidance through e-mails and group discussions. The guidance was not organized, nor was it formalized and distributed to homeownership center Quality Assurance Division managers as policy. However, homeownership managers told us that they referred to the miscellaneous, informal guidance when making decisions on whether to require lenders to indemnify materially deficient loans.

Local Staff Made Decisions Not to Follow Requirements

Quality Assurance Division staff at the homeownership centers were aware of the requirements to refer loans with evidence of fraud to OIG. They were also aware that HUD considered loans with evidence of fraud sufficiently deficient to justify a need for lenders to indemnify these loans. However, for various reasons, they decided not to follow the requirements. One homeownership center Quality Assurance Division manager did not consistently refer potentially fraudulent loans to OIG based on the belief that OIG did not want referrals of individual loans. This manager also believed that OIG would not prosecute parties involved in frauds on individual loans; therefore, the manager did not see a need to refer individual loans to OIG.

Other Quality Assurance Division managers at the homeownership centers said that they did not consistently pursue indemnifications for potentially fraudulent loans because they could not hold the lenders responsible for loans with evidence of fraud if they were not certain that the lender knew or should have known about the fraud when it submitted the loan for FHA insurance. Another Quality Assurance Division homeownership center manager said that indemnifications were not meant to be punitive. The manager considered it unjustified punishment against the lender when HUD required indemnifications on potentially fraudulent loans.

Increased Risk of Not Treating Lenders Uniformly

Lack of uniformity among homeownership centers when resolving material loan deficiencies increases HUD's risk of treating lenders inconsistently. By inconsistently requiring loan indemnifications, the homeownership centers held some lenders financially liable for potential defaults and related losses on loans that FHA should not have insured but did not hold other lenders responsible for the same loan deficiencies. Further, the FHA insurance fund incurs unnecessary losses when HUD does not obtain loan indemnifications when warranted.

In addition, if the homeownership centers are not uniform in resolving loan underwriting deficiencies and potentially fraudulent loans, lenders can receive conflicting and contradictory information regarding FHA requirements, causing confusion about FHA requirements and how HUD will enforce them. Further, lenders may seek underwriting guidance from the homeownership center that lenders have learned from past experience provides the most favorable outcome to the lender.

Insurance Fund Put at Unnecessary Risk of Loss

Because Quality Assurance Division staff did not refer loans with indications of fraud to OIG, OIG did not have the opportunity to pursue actions against the parties responsible for the fraudulent loans. In addition, failure to refer potentially fraudulent loans to OIG deprives OIG of important information needed to identify patterns of fraud that could lead to more significant fraudulent activity and much larger risks and losses to the FHA insurance fund.

Further, Quality Assurance Division staff placed the FHA insurance fund at unnecessary risk when they did not pursue indemnification agreements with the lenders submitting the potentially fraudulent loans. Of the 34 potentially fraudulent loans that HUD did not process according to its requirements, HUD did not obtain indemnifications on 16 loans. Eleven of the loans, with original mortgage amounts totaling more than $2 million, currently pose a risk of loss of more than $670,000 to the FHA insurance fund. The remaining five loans resulted in foreclosures, four of which caused losses to the insurance fund of more than $230,000 when HUD sold the properties. HUD has not yet sold the remaining property, but the loan poses a risk to the insurance fund of about $52,000. Appendix E shows details of the loans that have caused or could cause losses to the FHA insurance fund.

Recommendations

We recommend that HUD's Assistant Secretary for Housing – Federal Housing Commissioner

1A. Develop and implement effective policies and procedures to ensure uniform resolutions to loan underwriting deficiencies and handling potentially fraudulent loans.

1B. Coordinate with OIG to reevaluate the July 2003 memorandum of understanding between HUD and OIG regarding referring loans with evidence of fraud to OIG. HUD should ensure that its staff follow the resulting agreement.

1C. Require lenders to indemnify HUD for 11 actively insured loans with original mortgage amounts totaling more than $2.3 million. The projected loss is $670,113, based on the FHA insurance fund average loss rate of 29 percent for fiscal year 2005 (see appendix E).

1D. Require lenders to reimburse HUD for four loans for which HUD has already incurred losses totaling $233,351 (see appendix E).

1E. Require the lender to indemnify HUD for one loan for which HUD has paid a $181,168 claim but not yet sold the property. The projected loss is $52,539, based on the FHA insurance fund average loss rate of 29 percent for fiscal year 2005 (see appendix E).

SCOPE AND METHODOLOGY

Our review covered the period from January 1, 2004, through the present and was expanded as necessary. We accomplished our objective by conducting interviews with HUD headquarters staff and staff at the four homeownership centers: Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California. We reviewed federal regulations, HUD handbooks and guidebooks, policies and procedures at each homeownership center, and informal guidance on the lender monitoring processes–including matrices, memorandums, e-mails, and internal policies. In addition, we reviewed prior Government Accountability Office reports applicable to HUD's oversight of FHA-approved lender oversight.

We also reviewed the following reports and records at the homeownership centers for HUD's fiscal years 2004 through 2006:

- Files of 48 lender monitoring reviews conducted by Quality Assurance Division staff, including initial findings letters, loan origination documents, and all related correspondence between Quality Assurance staff and the lender;
- Files for 70 loans that lenders self-reported as containing material deficiencies, including loan origination documents and all related correspondence between Quality Assurance Division staff and the lender;
- Summary reports of lender monitoring reviews;
- Summary reports of loans that lenders self-reported; and
- Quality Assurance Division internal quality control review records.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse and Neighborhood Watch systems. We assessed the reliability of the data and found the data adequate to meet our audit objective. We also relied on computer-processed data contained in HUD's Approval/Recertification/Review Tracking System. We used these data for background purposes only and did not use the data to support our audit conclusions.

We assigned a value to the potential savings to HUD if it implements our recommendations for lenders to indemnify loans for which the homeownership centers referred loans to OIG but did not require indemnifications from the lenders. For those loans in which HUD has not yet incurred a loss, we applied FHA's average loss experience for fiscal year 2005 provided by HUD. We calculated the savings value at $670,113 for those properties currently actively insured, which is 29 percent of the original mortgage amount of $2,310,733. For the loan for which HUD has paid a claim but not yet sold the related property, we calculated the savings value at $52,539, or 29 percent of $181,168 in claims paid.

This report details HUD's noncompliance with a memorandum of agreement between HUD and OIG. The finding includes a recommendation for HUD to coordinate with OIG's Office of Investigation to reevaluate the agreement. Because the Office of Investigation is another office within the OIG, we are not independent with respect to that organization. Moreover, the scope of our review did not include an assessment of the Office of Investigation's compliance with the above referenced memorandum of agreement.

We performed the audit in accordance with generally accepted government auditing standards, except for the independence impairment and scope limitation described above.

We performed our audit from August 2006 through June 2007, including on-site work at the Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California homeownership centers and at HUD headquarters in Washington, DC.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies and procedures – Controls designed to ensure that FHA-approved lenders only submit loans for insurance that meet federal regulations.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

We did not identify any significant weaknesses.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1C		$670,113
1D	$233,351	
1E		$52,539

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 polices or regulations.

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

Implementation of our recommendations to require lenders to indemnify loans that were referred to OIG for fraud will reduce the risk of loss to the FHA insurance fund. The amounts above reflect that, upon sale of the mortgaged property, FHA’s average loss experience is about 29 percent of the claim amount based upon statistics provided by HUD.

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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

DEC 19 2007

MEMORANDUM FOR: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

FROM: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H

SUBJECT: Draft Audit – HUD Monitoring of FHA-Approved Lenders

This is in response to your memorandum dated November 20, 2007, transmitting the subject draft audit report, which is a modification to your previous submission dated July 2, 2007.

In its report the Office of Inspector General (OIG) stated that HUD's Quality Assurance Division (QAD) did not consistently remedy materially deficient or potentially fraudulent loans, thereby increasing the level of risk to the FHA insurance fund and minimizing the opportunity for OIG to pursue the parties responsible. The draft report maintains that the reasons consistent remedies were not applied to such loans were due to formal instructions not being established for QAD managers in the Homeownership Centers (HOCs) to use in seeking indemnifications from lenders for material underwriting deficiencies, as well as staff not following the necessary requirements for resolving these cases. The audit's single finding states "HUD's Quality Assurance Division did not always resolve materially deficient or potentially fraudulent loans consistently." We acknowledge that our process is not one hundred percent perfect. However, we continue to take the necessary steps to improve. Following are the Office of Housing's (Housing) comments to the draft audit.

Loan Indemnifications on Materially Deficient Loans Not Consistently Required

Comment 1

The OIG reviewed HUD's monitoring of FHA-approved lenders for the period January 1, 2004 through the present. During that period, QAD conducted over 2,300 lender reviews and examined more than 59,500 loans. For each loan evaluated in a QAD review it is important to consider all of the information provided by the lender, including alternative forms of income and employment verification that assist in making an informed decision about the borrower's ability to meet the terms of the mortgage, and what, if any, remedial action should be taken. For each case presented by OIG as candidates for indemnification, QAD determined that the lender furnished either the necessary evidence of borrower employment, assets and funds to close, or found that the deficiencies were not material violations. As a matter of procedure, deficiencies are examined closely to determine if additional evidence can be provided by the lender that may resolve the issue(s). Indemnification is warranted only in those cases in which it can be demonstrated that the deficiencies are material and/or that the lender knew or should have known that fraud had occurred.

www.hud.gov espanol.hud.gov

Adequate Indemnification Instructions Not Provided

Comment 2

It would be impractical and ineffective for QAD to have formalized instruction for each loan level scenario resulting from a lender review. It should be noted that specific guidance and instruction on the appropriate use of indemnifications and the policy for determining when deficiencies are considered material or immaterial was issued to management staff on November 11, 2005.

Potentially Fraudulent Loans Not Consistently Referred or Indemnified

Comment 3

Housing remains committed to reporting fraud and potential fraud to OIG's Office of Investigation. In fact, for the period covered by this audit, over 1,600 referrals were made to OIG. Nevertheless, to ensure uniformity in both Housing and OIG processes, staff from the Office of Lender Activities and Program Compliance met with OIG's Director, Criminal Investigation Division on November 28, 2007, to further refine the referral process and information to be submitted to the OIG Investigation staff.

Local Staff Made Decisions Not to Follow Requirements

Comment 4

Comment 5

The draft report states QAD staff were "also aware that HUD considered loans with evidence of fraud sufficiently deficient to justify a need for lenders to indemnify these loans. However, for various reasons, they decided not to follow the requirements." The requirement to which the report is referring is the November 2005 Office of Single Family Housing indemnification policy statement, which is misstated in Appendix C of the report. The policy actually states that indemnifiable deficiencies include instances where "potential fraud – discrepancies in income, assets, SSN, property are so great that the lender should have questioned the employment, asset/gift donor, borrower or appraisal information further as their falsification was evident prior to closing." In applying this policy it is necessary to consider the specific facts presented by each case, including information/documentation provided by the lender with respect to the borrower's income, employment, financial assets and other information, when determining loans that are at-risk for potential material deficiencies and/or fraud, as well as the appropriateness of the remedies available. In accordance with this policy statement, the referral of a potentially fraudulent loan to OIG does not automatically warrant indemnification; instead, staff considers the specific facts of each case to determine if the deficiencies are material and that the lender knew or should have known.

Comment 6

With respect to the statement that QAD staff made decisions not to follow requirements concerning referral of loans, it should also be noted that QAD made numerous referrals to OIG Investigations which were consistently declined, even in instances where fraud was identified. QAD provided the OIG with statements and specific examples to that effect during the audit interview process.

Comment 7

Increased Risk of Not Treating Lenders Uniformly

The report asserts that QAD staff in Single Family Homeownership Centers inconsistently required loan indemnifications, thereby placing some lenders at an unnecessary risk for defaults and related losses. QAD agrees that based on its November 2005 policy statement, material deficiencies warrant indemnification even when the loans are current or the lender has provided the necessary training to prevent future material deficiencies. QAD staff in each HOC will continue to evaluate each loan and apply the required remedies based on the individual circumstances of each case. Only in cases where material deficiencies are discovered which the lender knew or should have known, are indemnifications to be pursued.

Insurance Fund Put at Unnecessary Risk of Loss

Finally, the report states that the insurance fund was put at unnecessary risk of loss for 16 loans for which QAD did not pursue indemnification agreements with the lenders. Staff is reviewing each of the 16 loans, and will provide a response to the final audit. For each loan, where appropriate, Housing will describe the reason(s) the finding(s) was not considered material and/or the additional documentation submitted by the lender to cure or lessen the deficiency below the material threshold.

OIG Evaluation of Auditee Comments

Comment 1 Our report concludes that although the homeownership centers were generally consistent in resolving loan deficiencies, HUD should take additional action to reduce inconsistencies. We provided examples in the report to show how homeownership centers took inconsistent approaches to similar underwriting deficiencies and in resolving loan deficiencies. We maintain that HUD should take additional action to more uniformly apply lender monitoring and review procedures, findings, and actions.

Comment 2 We maintain that HUD should develop and implement effective policies and procedures to ensure uniform resolutions to loan underwriting deficiencies and handling potentially fraudulent loans. We believe that formalized instructions for evaluating and resolving similar loan-level scenarios would ensure more uniform treatment of loan deficiencies and the lenders causing the deficiencies.

Comment 3 We appreciate the Office of Single Family Housing's willingness to work with OIG regarding referrals of potential fraud. The Office of Single Family Housing should continue to coordinate with OIG and refer FHA loans with indications of fraud, using the parameters that HUD and OIG agree is appropriate.

Comment 4 To ensure that we did not mischaracterize HUD's internal policy statement, we revised appendix C to include more detail from the policy.

Comment 5 HUD's internal policy statement lists a potentially fraudulent loan as an example of a loan that presents a material risk to FHA and therefore, likely rises to the level of indemnification. We agree that generally potentially fraudulent loans likely rise to the level of indemnification. Therefore, we believe that absent an extraordinary reason to do otherwise, HUD should require the lender to indemnify a loan with evidence of fraud.

Comment 6 We continue to believe that the homeownership centers should refer potentially fraudulent loans to OIG and allow OIG to decide what actions are warranted. HUD should not refrain from referring loans that it believes OIG may decline to accept as a potential fraud case simply because OIG may have declined a similar referral in the past. While OIG evaluates the merit of referrals and takes actions it deems appropriate, OIG can make these decisions only if HUD refers potential fraud to OIG for consideration. As stated in comment 3, HUD should continue to coordinate with OIG and refer FHA loans with indications of fraud, using the parameters that HUD and OIG agree is appropriate.

Comment 7 We appreciate that HUD agrees it should require lenders to indemnify materially deficient loans even when the loan is current or the lender agrees to provide training to prevent future loan deficiencies. We encourage HUD to ensure that it pursues indemnifications when these situations exist.

Appendix C

HUD REQUIREMENTS FOR REFERRING AND INDEMNIFYING FRAUDULENT LOANS

HUD Handbook 4060.1, REV-2, paragraph 8-3, provides that fraud and suspected illegal activities are to be referred to OIG.

The Quality Assurance Division guide requires staff to always refer fraud issues to OIG.

A July 2003 memorandum of understanding between HUD and OIG states that the homeownership centers should immediately refer evidence of fraud to OIG. This agreement requires that if HUD staff disclose evidence of fraud during a lender monitoring review, they should immediately refer the loan to OIG. OIG has 15 days from its receipt of the referral to notify the homeownership center of OIG's request to withhold a findings letter to the lender and the basis for the request.

A November 2005 Office of Single Family Housing internal policy statement provides examples of unacceptable loan deficiencies that HUD determined present a material risk to FHA. The policy states that the examples provided, which include potentially fraudulent loans, likely rise to the level that HUD should require the lender to indemnify the loan. The policy describes potential fraud issues as discrepancies in income, assets, Social Security number, and property that are so great that the lender should have questioned the employment, asset/gift donor, borrower, or appraisal information further as their falsification was evident prior to loan closing.

Appendix D

POTENTIALLY FRAUDULENT LOANS FOR WHICH HUD DID NOT FOLLOW REQUIREMENTS

		Referred to OIG	Not referred to OIG	Not referred to OIG	Not referred to OIG
Homeownership center	FHA case number	Not indemnified	Not indemnified	Indemnified	Paid in full
Denver	052-3259485	x			
Denver	052-3472629	x			
Denver	052-3495688	x			
Philadelphia	261-8250199	x			
Philadelphia	261-8495860	x			
Philadelphia	261-8942016	x			
Philadelphia	352-5334703	x			
Philadelphia	352-5414984	x			
Denver	491-8542532	x			
Santa Ana	023-2281607		x		
Atlanta	105-1700716		x		
Atlanta	105-2095993		x		
Santa Ana	431-4026298		x		
Santa Ana	561-7278627		x		
Santa Ana	561-7975685		x		
Santa Ana	561-8245677		x		
Santa Ana	023-0931922			x	
Santa Ana	023-1181861			x	
Santa Ana	048-2501803			x	
Santa Ana	048-2736718			x	
Santa Ana	048-4238622			x	
Santa Ana	121-2148756			x	
Santa Ana	121-2270946			x	
Santa Ana	332-3952378			x	
Santa Ana	332-4187463			x	
Santa Ana	332-4396076			x	
Santa Ana	491-7872340			x	
Santa Ana	561-7791027			x	
Santa Ana	561-8071652			x	
Santa Ana	023-2101144				x
Atlanta	092-9187016				x
Santa Ana	332-4138541				x
Santa Ana	431-3886018				x
Santa Ana	431-3927850				x

Appendix E

POTENTIALLY FRAUDULENT LOANS WITHOUT INDEMNIFICATIONS

FHA loan information		Potential monetary savings		
Homeownership center	**FHA case number**	**Original mortgage amount of active loans**	**Amount of claim paid**	**Amount of losses incurred**
Santa Ana	023-2281607	$ 63,995		
Santa Ana	431-4026298	$ 180,172		
Santa Ana	561-7278627	$ 221,523		
Santa Ana	561-8245677	$ 214,582		
Santa Ana	561-7975685			$ 38,155
Philadelphia	261-8250199	$ 72,758		
Philadelphia	261-8495860	$ 172,788		
Philadelphia	261-8942016	$ 167,044		
Philadelphia	352-5414984	$ 392,800		
Philadelphia	352-5334703	$ 455,836		
Atlanta	105-1700716	$ 165,434		
Atlanta	105-2095993	$ 203,801		
Denver	491-8542532		$ 181,168	
Denver	052-3495688			$ 58,793
Denver	052-3472629			$ 62,241
Denver	052-3259485			$ 74,162
Totals		**$ 2,310,733**	**$ 181,168**	**$ 233,351**
Potential loss = 29%*		**$ 670,113**	**$ 52,539**	
Total potential monetary savings		**$ 670,113**	**$ 52,539**	**$ 233,351**

* Estimated future losses are based on HUD's average loss rate of 29 percent of claims paid from the FHA insurance fund for fiscal year 2005.