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TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing Commissioner, H
Sharon Lundstrom, Director, Servicing and Loss Mitigation Division, HUFM

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FROM: Hanh Do, Director, Information Systems Audit Division, GAA

SUBJECT: Final Audit Report: Review of Single-Family Partial Claims Collection Process

HIGHLIGHTS

What We Audited and Why

We audited the single-family partial claims collection process and its effectiveness in protecting the Federal Housing Administration's (FHA) insurance fund. Our overall objective was to determine whether the single-family partial claims program operated effectively and efficiently to minimize costs to the insurance fund and collect amounts due in a timely manner. This review was a spin-off of our previously conducted audit of selected FHA major applications' information security controls.

What We Found

The National Service Center (NSC) and its contractors did not properly implement a cohesive partial claims collection process to ensure that partial claims were serviced in a timely manner. The NSC did not (1) fully develop and implement written policies and procedures, (2) define follow-up procedures for the forbearance plan option, (3) promptly transfer partial claims to the Albany Financial Operations Center, and (4) actively track and monitor lender billing.

What We Recommend

We recommend that the Assistant Secretary for Housing ensure that the NSC formulates and implements procedures to comply with federal regulations and enhance training provided to its contractors so that debts can be transferred to the Financial Operations Center in a timely manner.

We further recommend that the Director of the Servicing and Loss Mitigation Division develop procedures to pursue lenders for administrative offsets in a timely manner and to improve the forbearance plans. We also recommend that the Single Family Mortgage Asset Recovery Technology system be fully implemented as the one system of record for partial claims.

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 auditee with a copy of the report on October 8, 2008, requesting a response by October 22, 2008. The auditee requested an extension to the response date to November 7, 2008. We also granted additional time until November 19, 2008. However, the auditee did not provide a written response to the report by that date, therefore, no auditee comments are included in this report.

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BACKGROUND AND OBJECTIVES

The Federal Housing Administration (FHA) provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. We recently evaluated the Single Family Insurance Claim Subsystem and identified deficiencies with two types of insurance claims that are processed in the system, deed in lieu of foreclosure and preforeclosure sale.[1] These deficiencies led us to follow up on additional insurance claim types processed in the claims system including partial claims.

In an effort to keep homeowners in their homes and to mitigate losses to the insurance fund, the loss mitigation program was established in 1996. This program allows servicing lenders to use the following five primary tools: special forbearance, loan modification, partial claim, preforeclosure sale, and deed in lieu of foreclosure. A partial claim is a loss-mitigation option that is used when a lender advances funds on behalf of a borrower in an amount necessary to reinstate a delinquent loan (not to exceed the equivalent of 12 months' principal, interest, taxes, and insurance). The borrower will execute a promissory note and create a secondary mortgage payable to the U.S. Department of Housing and Urban Development (HUD). Currently, these promissory or "partial claim" notes assess no interest and are not due and payable until the borrower either pays off the first mortgage or no longer owns the property.

The National Service Center (NSC) works to help FHA homeowners by working with lenders to administer and offer the loss mitigation program. The NSC is responsible for servicing, collecting, and managing partial claims. It provides direction and training to lenders and housing counseling agencies, which are then better able to provide assistance to homeowners. Additionally, the NSC works closely with customers who have FHA-insured loans with the goal of foreclosure prevention.

Our overall objectives were to determine whether the single-family partial claim program operated effectively and efficiently to minimize costs to the insurance fund and collect amounts due in a timely manner. Also, we reviewed whether HUD complied with applicable federal requirements as they relate to this audit. The criteria that we used during our audit included circulars issued by the Office of Management and Budget, HUD's own policies and procedures, the *Federal Register*, and HUD mortgagee letters.

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[1] Audit Report No. 2008-DP-0004, "Review of Selected FHA Major Applications' Information Security Controls," dated June 12, 2008.

RESULTS OF AUDIT

Finding 1: The Single-Family Partial Claims Collection Process Was Ineffective

The NSC did not consistently pursue the collection of partial claims. Of 48 partial claims reviewed, 29 had servicing deficiencies. Specifically, the NSC did not (1) transfer partial claims to the Albany Financial Operations Center for debt collection in a timely manner, (2) bill lenders within the required timeframe, (3) follow up with borrowers on balances owed, and (4) properly account for all partial claims in its Single Family Mortgage Asset Recovery Technology (SMART) system. This condition occurred because the systems used in the collection process were not integrated, contractors involved in the process lacked appropriate training, and policies and procedures did not adequately address various collection methods and processing steps. As a result, the FHA insurance fund was at risk of losing thousands of dollars in partial claim collections, and balances to the partial claim portfolio could remain uncollected. The total uncollected balance for the 29 partial claims was $175,726.

A partial claim is a loss-mitigation tool used by a lender when it advances funds on behalf of a borrower in an amount necessary to reinstate a delinquent loan. The borrower executes a promissory note, creating a secondary mortgage payable to HUD. This promissory note or "partial claim" is not due and payable until the borrower pays off the first mortgage or no longer owns the property. We randomly selected 48 partial claims from a universe of 2,502 that were active for collection (i.e., due and payable) at the time of our review. Of those 48 loans, we identified 29 partial claims that had servicing deficiencies.

NSC Did Not Transfer Partial Claims to the Financial Operations Center in a Timely Manner

Of 29 partial claims with deficiencies, 10 were not transferred to the Financial Operations Center for debt collection in a timely manner. According to Office of Management and Budget Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables, "agencies are required to transfer a debt or claim that has been delinquent 180 days or more to Treasury or a Federal debt collection center designated by Treasury." The Financial Operations Center is the federal debt collection center designated by the U.S. Department of the Treasury for HUD.

Of the 10 loans that were not transferred to the Financial Operations Center, we found instances in which the borrower agreed to a partial claim forbearance plan,[2] and after the one-year expiration date, the remaining partial claim balance was not transferred to the Financial Operations Center or followed up with lender billing. Forbearance letters that were sent to the borrowers specifically stated that after the one-year term, NSC would take administrative actions to collect on the partial claims; that is, NSC would transfer these partial claims to the Financial Operations Center. We also found an instance in which the borrower with a partial claim entered into bankruptcy proceedings and the court dismissed the bankruptcy case. However, the NSC did not exercise its right to pursue or send the partial claim to the Financial Operations Center.

NSC Did Not Bill Lenders in a Timely Manner

Of 29 partial claims with deficiencies, 15 were not lender billed in a timely manner. The NSC did not automatically bill lenders six months after the partial claim was initiated, and documents had not been received as required by Mortgagee Letter 2003-19.[3] Also, according to 24 CFR (*Code of Federal Regulations*) 203.371, Partial Claim, "The mortgagor must execute a mortgage in favor of HUD with terms and conditions acceptable to HUD for the amount of the partial claim under § 203.414(a)."[4] The lender is also required to forward these documents to HUD. The NSC is responsible for actively billing lenders for partial claim balances or for consistently requesting documents (e.g., promissory note and the subordinate deed of trust) from the lenders to lawfully collect on the partial claim.

If the NSC is unable to obtain documents from the lenders, it should bill the lender for the incentive fee and the full amount of the partial claim or administratively offset future funds from the lender. The NSC had policies and procedures in place for this task. However, lender billing and administrative offsets did not always occur on a timely basis. In cases in which the NSC did not

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[2]The partial claim forbearance plan was created by the NSC to aid the borrower in repaying the partial claim. The plan requires that the borrowers contact the NSC within 30 days of receiving the initial demand letter and pay an initial one-third payment and pay the remaining balance within one year. If the balance is not paid in full by the expiration date, partial claims will be transferred to the Financial Operations Center.

[3] Mortgagee Letter 2003-19, Partial Claims: Program Changes and Updates, section Q, states, "It is the responsibility of the mortgagee to deliver the original promissory note and recorded mortgage to HUD's servicing contractor's business address listed in Section G of this Mortgagee Letter, as soon as possible, but in any case, no later than six (6) months from the execution date of the partial claim note and security instruments."

[4] 24 CFR 203.414(a), Amount of payment—partial claims, (a) Claim Amount, states, "Where a claim for partial insurance benefits is filed in accordance with §203.371, the amount of the insurance benefits shall consist of the arrearage not to exceed an amount equivalent to 12 monthly mortgage payments, and any costs prescribed by HUD related to the default."

request partial claim documents from the lenders in a timely manner, the partial claims were not serviced.

NSC Did Not Demand Partial Claims from Borrowers

The NSC did not demand the balance due and payable from the borrowers for 3 of the 29 partial claims with deficiencies. We noted that when a borrower's bankruptcy was dismissed, follow-up on the partial claim did not occur. After the bankruptcy was dismissed, the NSC should first demand the partial claim from the borrower. If there is no contact within 30 days, the loan should be transferred to the Financial Operations Center. For all three loans for which the balance should have been demanded from the borrower, the promissory note and mortgage documents were in the file, and the NSC still had the opportunity to send the partial claims to the Financial Operations Center for collection after 30 days but did not do so.

NSC Did Not Maintain Accurate Records

Of the 29 partials claims with deficiencies, one was not appropriately accounted for in the NSC SMART system. The NSC did not release the partial claim from its system after the claim was transferred to the Financial Operations Center for debt collection. Once partial claims are sent to the center and accepted into its database, the claims are to be released from SMART. However, the partial claim was still on record in SMART after being transferred. This error could potentially result in accounting issues for both the NSC and the Financial Operations Center. The partial claim debt should only be carried as a receivable on one department's financial records. If the debt is not properly accounted for, there could be a potential misstatement.

NSC Had an Ineffective Processing System

The NSC and the Office Single Family Housing in headquarters used four systems[5] for the partial claims collection process. While partial claims

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[5] Four systems are

- Single Family Mortgage Notes/Strategy (SFMN) - A subsystem that records, maintains, and monitors complete commercial mortgage servicing activities for HUD Secretary-held mortgages.
- Single Family Insurance System (SFIS) - An automated system that is the primary repository of FHA's single-family mortgage insurance inventory.

information interfaced among the four systems, contractors needed to perform a manual reconciliation because not all information was automatically transferred among the systems. For example, partial claims that needed to be transferred to the Financial Operations Center on a monthly basis were tracked using an Excel spreadsheet created monthly. Partial claims that were not ready to be sent, due to lacking documents such as a promissory note or mortgage, remained on the manually tracked Excel spreadsheet. There was no follow-up procedure in place to ensure that the partial claims that had not been transferred were completed for a future monthly transfer. This method allowed manual errors and the possibility that partial claims would not be collected in a timely manner or at all. The use of these four systems, rather than use of SMART as the one system of record, caused processing errors and inadequate controls to ensure that the collection process was completed in an efficient manner.

NSC Did Not Provide Appropriate Training to Its Contractors

HUD staff did not provide appropriate and adequate partial claim collection training to its contractors. The lack of formal training could potentially cause a misunderstanding of the policies and procedures and lead to poor execution of the collection process. Although policies and procedures were recently modified, training had not been held to ensure a full understanding of the new procedures.

Policies and Procedures Needed Improvement

While HUD's new contractor, C & L Service Corporation, and its subcontractor, Morris-Griffin Corporation, had made significant progress toward a more cohesive and effective collection process, policies and procedures needed improvement. Although HUD's expectations were clearly noted in the statement of work and the contractor had delivered on its expectations, the adequacy and completeness of the deliverable (i.e., policies and procedures that fully address the partial claim collection process) were questionable. Specifically, policies and procedures did not adequately address follow-up collection methods or include collection process steps for demand letters, forbearance plans, or bankruptcy. According to NSC staff, they were continually working with the contractors to improve the servicing of the partial claim notes and mortgages.

- Credit Alert Interactive Voice Response System (CAIVRS) – Created in 1988 for the Office of Housing to check the credit worthiness of applicants for FHA-insured loans.
- Single Family Mortgage Asset Recovery Technology (SMART) – Created by NSC contractors to maintain and monitor the loan servicing process for HUD Secretary-held mortgages. Currently going through certification and accreditation to become an official system. Not in Inventory of Automated Systems.

NSC Was Making Progress in Addressing Weaknesses

We provided the NSC with a list of the deficiencies noted, and it responded with its corrective actions on the 29 partial claims reviewed. Specifically, the NSC was able to appropriately address 24 of the partial claims.

Although the collection process was inefficient, the NSC was working to create a more consistent collection process. Its efforts were evident when reviewing its newly developed policies and its actions to address deficiencies identified. The NSC was also reviewing its policies and procedures to determine areas requiring a more proactive approach.

Conclusion

Absent a streamlined, efficient, and effective collection process, the FHA insurance fund is at risk of losing hundreds of thousands of dollars. The total unpaid principal balance for the 48 partial claims was approximately $291,769. The 29 partial claims that had weaknesses had a total uncollected balance of approximately $175,726. While steps to continue servicing had been initiated, the balance of these partial claims remained uncollected. When the partial claims are not actively serviced, they maintain an open status, and followup was not completed to ensure their collection. The NSC put the FHA insurance fund at risk by not collecting on the partial claims in an effective and timely manner. This occurred because policies and procedures did not adequately address various collection methods and processing steps, contractors involved in the process lacked appropriate training, and systems used in the collection process were not integrated.

Partial claims that are not sent to the Financial Operations Center for debt collection in a timely manner have a higher risk of being uncollected. The center uses collection techniques that are more rigorous than those available to the NSC. From November 2006 to March 2008, 5,421 partial claims were transferred to the center, and 1,154 (21 percent) had been collected and/or closed.

Recommendations

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

1A. Ensure that debts from the NSC are transferred to the Albany Financial Operations Center for debt collection in a timely manner.

1B. Formulate and implement written policies and procedures to ensure that the NSC complies with federal debt collection guidance.

1C. Ensure that the NSC provides training to its contractor. Training should be provided to new contractors and developed to specifically entail servicing and collection procedures rather than industry standards regarding loss mitigation.

We recommend that the Director of the Servicing and Loss Mitigation Division

1D. Ensure the implementation of SMART to allow for one system of record for all partial claim transactions.

1E. Develop or enhance procedures to include guidance for forbearance plans.

1F. Actively pursue lender-billed partial claims by administratively offsetting lender accounts on future partial claims.

1G. Develop a payment schedule for borrowers who enter into a forbearance plan with the NSC for the additional two-thirds payment or collect the initial one-third payment for forbearance plans and immediately transfer the partial claims to the Financial Operations Center for continued collection servicing.

SCOPE AND METHODOLOGY

We performed the audit

- From February through August 2008,
- At HUD headquarters in Washington, DC, and the National Servicing Center in Tulsa, Oklahoma, and
- In accordance with generally accepted government auditing standards.

We reviewed the written documents and procedures of the partial claim process. We focused on the adequacy of those documents in comparison with federal regulations and HUD requirements. We compared the partial claim collection steps that were completed to those steps that were written in the partial claims collection guidance.

We used a random selection sampling method to evaluate the partial claim collection process. We randomly selected 48 loans from a total universe of 2,502 loans that were reported currently active. The original partial claim transaction dates for our audit were from the partial claim inception in 1997 to December 2007. The sample we selected had four termination codes: types 11, 22, 23, and 25.[6]

To accomplish our objectives, we reviewed policies and procedures, interviewed NSC and Financial Operations Center staff, and obtained and analyzed supporting documentation. The interviews with the NSC were conducted to determine roles and responsibilities and to obtain an understanding of the partial claims collection process. We were granted access to the SMART system and researched each of the 48 loans in depth and identified the deficiencies. We looked at the promissory note, and mortgage if available, and notes section within SMART.

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[6] Type 11 - Paid in full (prepayment) - The first mortgage is paid off when the borrower either sells the property or refinances through a non-FHA-insured lender. The FHA insurance is subsequently terminated.

Type 22 - Transfer with reinsurance

Type 23 – Refinance - The borrower refinances with another FHA-insured mortgage. The subordinate mortgage may not be paid off if it was used to bring the borrower current to permit refinancing. Consequently, the property is insured under the new FHA case number.

Type 25 - Nonconveyance claim (partial claim preforeclosure sale) - Nonconveyance claim, preforeclosure sale (PFS), Claim Type 07. The partial claim (type 33) amount should be considered by the lender in the analysis of the borrower's eligibility for the PFS program.

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:

- Up-to-date written policies and procedures,
- Compliance with federal requirements, and
- Design and implementation of policies and procedures.

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

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

- The single-family partial claims collection process was not appropriately executed (finding 1).
- Written policies and procedures were inadequate and not implemented (finding 1).

APPENDIXES

Appendix A

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

Recommendation number	Funds to be put to better use 1/
1A	$57,451
1F	$84,098
1G	$34,177
	$175,726

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. 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. In this instance, the $175,726 represents the principal balance on the 29 partials claims that we identified with deficiencies. This amount was not collected upon, or servicing steps were not completed in order to ensure this amount would be collected. The NSC needs to ensure that the remaining balance of the 29 partials claims is collected.