audit report

Issue Date April 18, 2011	
Audit Report Number 2011-LA-0002	

TO: Vicki B. Bott, Deputy Assistant Secretary for Single Family Housing, HU

Tanya E Schulze

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

SUBJECT: HUD Did Not Always Follow its Requirements for the Preclosing and Postclosing Review of Mortgage Files Submitted by New Direct Endorsement Lenders

HIGHLIGHTS

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) preclosing and postclosing loan review of new Federal Housing Administration (FHA) direct endorsement lenders. This audit was conducted as part of the HUD Office of Inspector General's (OIG) fiscal year 2010 annual audit plan and was designed to follow up on selected findings in the Government Accountability Office's November 2004 audit report on HUD's oversight of FHA lenders. Our audit objectives were to determine whether HUD followed its guidance when (1) reviewing the initial loans underwritten by new FHA direct endorsement lenders and (2) performing the postendorsement technical review of all of the initial loans endorsed by newly approved direct endorsement lenders.

What We Found

Although improvements had been made, HUD continued to grant unconditional direct endorsement authority to some new FHA direct endorsement lenders (new lenders) that did not successfully complete HUD's requirements for unconditional direct endorsement authority. Specifically, 7 of the 155 lenders reviewed did not successfully complete the

15 required test cases but, nevertheless, were granted unconditional direct endorsement authority. These lenders generally submitted 15 or more test cases; however, some of these cases did not count toward HUD's requirements because they were sponsored (i.e., underwritten) by other lenders. In other instances, lenders did not complete the required number of manually underwritten test cases. FHA could incur unnecessary risk if HUD continues to approve new lenders that did not fully complete the minimum test case requirements. Direct endorsement lenders with unconditional authority can underwrite and close loans without prior approval from HUD. Therefore, FHA is committed to insure these loans, whether or not the lender has demonstrated the capacity to comply with FHA underwriting requirements.

Also, HUD did not follow its guidance for the postendorsement technical review of all loans initially endorsed by new lenders that were approved for unconditional direct endorsement authority (newly approved lenders). HUD only performed the required reviews on approximately half of the initial loans endorsed. This condition occurred in part because the computerized system HUD used to select loans for review was improperly programmed. HUD officials have taken steps to address the issue. Also, there was no single report available to properly monitor newly approved lenders, but officials were working to create one. As a result, HUD's monitoring of its newly approved lenders' performance was weakened.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require HUD's Homeownership Centers to improve controls to ensure that they follow the guidance for granting new lenders unconditional direct endorsement authority. Additionally, we recommend that the Deputy Assistant Secretary for Single Family Housing ensure that the required number of cases endorsed by newly approved lenders is selected for review and establish a report that could be used by the Homeownership Centers to properly monitor the performance of these lenders.

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 discussed our results with the Homeownership Centers and HUD headquarters during the audit and at the exit conference on March 25, 2011. HUD provided written comments to our draft report on April 12, 2011. HUD generally agreed with the findings and recommendations. The complete text of HUD's response, along with our evaluation of that response, can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVES

The Federal Housing Administration (FHA) was created by Congress in 1934 and is the largest insurer of mortgages in the world, insuring more than 34 million properties since its inception. FHA's mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to make loans to otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. The U.S. Department of Housing and Urban Development (HUD) oversees FHA and participating lenders.

Direct endorsement is authorized under Section 203(b) of the National Housing Act and allows FHA-approved lenders to underwrite and close loans without prior approval from HUD. Virtually all single-family FHA mortgage lending is done through direct endorsement. This process makes it easier and quicker for people to buy homes by allowing them to get mortgage insurance directly with an FHA-approved lender. To obtain unconditional direct endorsement authority, lenders must first receive approval from HUD's Office of Single Family Housing to become an FHA direct endorsement lender. The new FHA direct endorsement lender (new lender) must then submit a written request to the appropriate HUD Homeownership Center to be placed in the preclosing review test phase. The purpose of the preclosing review test phase is to ensure that the lender's underwriting complies with FHA requirements. Upon satisfactory completion of the preclosing review test phase (preclosing phase), the lender receives unconditional approval to directly endorse FHA loans (newly approved lender). The four Homeownership Centers, located in Atlanta, GA, Denver, CO, Philadelphia, PA, and Santa Ana, CA, are responsible for overseeing lenders and insuring single-family FHA mortgages for their designated geographic areas.

HUD's Office of Single Family Housing established specific guidelines for approval of unconditional direct endorsement authority. While in the preclosing phase for purchase forward mortgages, new lenders must submit a minimum of 15 acceptable mortgage loan application "test cases" for review by the Homeownership Center within a 12 month period. Homeownership Center underwriters perform a detailed review of each loan application to determine whether it is underwritten in compliance with FHA requirements. If the loan application demonstrates acceptable underwriting, the Homeownership Center issues a firm commitment to the new lender.

After new lenders complete the preclosing phase and are granted unconditional direct endorsement authority, they enter the 100 percent postendorsement technical review (PETR) phase. During this phase, the appropriate Homeownership Center performs an underwriting review of 100 percent of the first 30 loans submitted and endorsed by the newly approved lender. HUD changed the requirements to the first 10 loans, effective February 15, 2010. This monitoring ensures that newly approved lenders continue to successfully underwrite acceptable mortgages.

Our objectives were to determine whether HUD followed its guidance when reviewing the initial loans underwritten by new lenders and when performing the PETR of all of the initial loans endorsed by newly approved lenders.

RESULTS OF AUDIT

Finding 1: Lenders Were Not Always Granted Unconditional Direct Endorsement Authority in Accordance With HUD's Requirements

Although improvements had been made, HUD continued to grant unconditional direct endorsement authority (unconditional authority) to some new lenders that did not successfully complete the requirements for the preclosing phase. In 2004, the Government Accountability Office (GAO) reported that 7 of the 49 lenders it reviewed did not submit the required number of test cases. In response, HUD updated its guidance; however, our follow-up review of 155 newly approved lenders determined that 7 were granted unconditional authority without successfully completing the required number of preclosing test cases. Some of the test cases submitted by these lenders did not qualify for the preclosing phase because they were sponsored (underwritten) by other lenders. In other instances, lenders did not complete the required number of manually underwritten test cases. This condition occurred because the Homeownership Centers did not consistently monitor all lenders and ensure that they complied with HUD's preclosing test case requirements. Since direct endorsement lenders with unconditional authority underwrite and close mortgage loans without prior HUD review or approval, FHA could incur unnecessary risk if HUD continues to approve new direct endorsement lenders that did not complete the minimum test case requirements.

GAO Reported That HUD Did Not Always Follow Its Guidance

In its November 2004 audit report on HUD's oversight of FHA lenders,[1] GAO reported that HUD deviated from its guidance when granting direct endorsement authority to some of the 49 lenders that were approved between October 1, 2002, and April 30, 2004. Specifically, GAO determined the following:

- 7 of the lenders did not submit at least 15 mortgage loans that were rated "good" or "fair";[2]
- 2 lenders were granted direct endorsement authority, although the last 5 consecutive loans they submitted were not rated "good" or "fair"; and[3]
- 1 lender exceeded the allowed 1-year probationary period, and 8 lenders submitted more than the 30 loans allowed before being granted direct endorsement authority.

[1] GAO audit report 05-13, "Progress Made, but Opportunities Exist to Improve HUD's Oversight of FHA Lenders"
[2] HUD changed the ratings of test cases to "conforming," "deficient," and "unacceptable," effective January 23, 2007.
[3] This was no longer a requirement for the preclosing phase during the scope of our audit.

In response to the audit report, HUD issued updated instructions in May 2005 for the Homeownership Centers to use when granting unconditional authority to new lenders.

Seven Lenders Did Not Successfully Complete the Required Number of Test Cases

The Homeownership Centers generally had controls in place to track lenders in the preclosing phase but inconsistently monitored compliance with specific test case standards. Our review of 155 lenders determined that 7 did not complete the required number of test cases in accordance with the standards; however, the Homeownership Centers granted these lenders unconditional authority. In 2010, these seven lenders endorsed 1,408 FHA loans with mortgages totaling $276.2 million.

Homeownership Centers	Lenders reviewed	Lenders that did not submit the required number of test cases
Atlanta	40	5
Denver	36	0
Philadelphia	40	2
Santa Ana	39	0
Total	**155**	**7**

According to HUD's May 31, 2005, memorandum to the Homeownership Centers that set forth the standards for the preclosing review phase[4], lenders were required to submit a minimum of 15 preclosing test cases that had been successfully underwritten and processed. The memorandum further stated that 10 of the 15 preclosing test cases were required to be manually underwritten and 5 could be a combination of automated underwriting and streamline refinance loans. However, as of March 25, 2009, HUD had changed the requirements to state that 5 of the required 15 preclosing test cases are required to be manually underwritten and 10 may be a combination of automated underwriting and a maximum of 2 streamline refinance loans. For lenders requesting direct endorsement authority to underwrite home equity conversion mortgage (HECM) loans, lenders must submit a minimum of five eligible HECM test cases for review.

The lenders that were inappropriately granted unconditional authority generally submitted 15 or more preclosing test cases; however, Homeownership Center officials apparently failed to note that in some instances, the test cases should not have been counted toward the 15 test case requirement. For example, some cases were counted, although they were sponsored by other lenders[5]. In other instances, the lenders did not

[4] The subject of the memo was "Standards for Granting Unconditional [Direct Endorsement] Authority and Monitoring Mortgagee Performance."

[5] Lenders that originate loans but have a sponsor do not perform the underwriting for those loans. Among other responsibilities for the loan, the originator takes the initial application from the borrower(s), closes the loan after it has been underwritten, and submits the loan package to HUD for insurance endorsement. However, the sponsor performs the underwriting.

submit the required number of manually underwritten test cases. One lender, which was granted unconditional authority on January 8, 2009, submitted a total of 13 preclosing test cases; however, it only completed 6 of the 10 required manually underwritten test cases.

The Homeownership Centers' Controls Were Not Always Effective

The Homeownership Centers followed similar processes to track and monitor the lenders in the preclosing phase. The Denver and Santa Ana Homeownership Centers created internal databases that tracked the number of test cases submitted by each lender, while the Atlanta and Philadelphia Homeownership Centers used manual tracking logs. In general, the Homeownership Centers assigned each lender a HUD underwriter as the point of contact but assigned the test cases to anyone on the preclosing team of underwriters. In addition, most of the Homeownership Centers relied on the lenders to alert the point of contact when the required number of cases was completed. After lenders submitted the 15 required test cases, each Homeownership Center had designated officials to be responsible for verifying the test cases listed on the tracking logs. The supervisors then reviewed the tracking logs and approved lenders for unconditional authority.

The Homeownership Centers' process controls were not always effective. For example, the tracking logs were not always properly maintained. In some instances, they did not contain all of the test cases that were submitted by lenders, had incorrect loan types (i.e., manual or automated underwriting) entered, and did not indicate whether a firm commitment had been issued. Therefore, it was difficult to verify that lenders successfully completed the 15 required test cases. In addition, officials sometimes reviewed an excessive number of extra test cases before granting lenders unconditional authority. Specifically, for 8 of the 155 lenders reviewed, officials reviewed an average of 10 to 11 extra test cases.[6] Without controls in place to prevent processing so many extra test cases, HUD may cause avoidable delays to granting lenders unconditional authority.

Conclusion

HUD established a preclosing review test phase that new lenders must succesfully complete before they can underwrite and close FHA-insured mortgage loans without prior HUD review or approval. Although HUD's implementation of its preclosing phase improved after it issued updated instructions to address the issues reported by GAO in 2004, HUD continued to grant unconditional authority to some lenders that did not

[6] HUD officials noted that lenders can submit multiple test cases at one time. Therefore, our results excluded lenders with up to four extra cases.

successfully complete the preclosing phase. This condition occurred because the Homeownership Centers did not consistently monitor the lenders in the preclosing phase. Because FHA is committed to insure loans endorsed by all newly approved lenders, HUD could incur unnecessary risk if it continues to approve some lenders that did not meet the minimum test case requirements to demonstrate their capacity to comply with FHA underwriting requirements.

Recommendation

We recommend that the Deputy Assistant Secretary for Single Family Housing

1A. Require the Homeownership Centers to improve controls to ensure that they follow the guidance for granting unconditional authority, thus ensuring that lenders are not approved without meeting the required preclosing phase requirements.

Finding 2: HUD Did Not Perform the Postendorsement Technical Reviews for Newly Approved Lenders in Accordance With Its Requirements

In response to GAO's 2004 audit report showing that the Homeownership Centers only reviewed about 7 percent of the lenders' initial 30 FHA-insured loans, HUD made changes to its FHA loan activity tracking systems[7] to ensure that the initial loans endorsed by newly approved lenders were reviewed. However, our follow-up review determined that the Homeownership Centers only reviewed approximately half of the required number of initial loans for newly approved lenders. This condition occurred because the system was not properly programmed to automatically select for review the initial loans endorsed by newly approved lenders. Further, the Homeownership Centers did not properly monitor the performance of newly approved lenders because they used automated reports that did not contain all of the information necessary to do so. Although HUD continually monitored all FHA lenders by reviewing endorsed loans that met certain criteria, it did not ensure that newly approved lenders continued to underwrite all of their initial loans[8] in an acceptable manner. As a result, HUD's monitoring of its newly approved lenders' performance was weakened.

GAO Reported That HUD Did Not Always Follow Its Guidance

In its November 2004 audit report on HUD's oversight of FHA lenders, GAO reported that the Homeownership Centers did not follow HUD's guidance stating that HUD underwriters should perform [post-endorsement] technical reviews on 100 percent of at least the first 30 FHA-insured loans made by newly approved lenders—the underwriters had reviewed only about 7 percent of the required initial 30 loans. According to Homeownership Center officials, they did not always select the first 30 loans to review because some of a lender's early loans may have been made by a new branch office of which they were unaware. Also, the FHA loan activity tracking system did not automatically maintain the 100 percent designation used to flag a newly approved lender's early loans for review.

In response to GAO's audit report, HUD published release notes outlining changes to FHA's loan activity tracking systems in April 2006 that allowed the Homeownership Centers to establish a review rate of 100 percent through a "review rules" function. This measure helped to ensure that the first 30 loans made [endorsed] by new direct endorsement lenders were reviewed as required.

[7] Computerized Homes Underwriting Management System (CHUMS) and FHA Connection
[8] Streamline refinances were omitted from the 100 percent review requirement.

Initial Loans Endorsed by Newly Approved Lenders Were Not Always Reviewed

According to HUD's requirements, newly approved lenders were automatically placed into 100 percent PETR status for a minimum of the first 30 loans endorsed (the 100 percent PETR phase). Through the release notes for HUD's Computerized Homes Underwriting Management System (CHUMS), HUD changed the requirements to the first 10 loans, effective February 15, 2010. After Homeownership Center officials granted a lender unconditional authority, they entered the date into CHUMS, which was programmed to automatically select the initial endorsed loans to undergo PETRs. However, for 120 of the 125 lenders reviewed for the 100 percent PETR phase, some of the initial loans were skipped and/or the required number of initial loans (30 or 10) did not undergo a PETR as required. We estimated that the Homeownership Centers only performed PETRs on about half of the required initial loans. For example, a HUD Neighborhood Watch system report showed that in one case, the Homeownership Center only reviewed 3 of the required initial 10 loans endorsed by a newly approved lender. During the audit, HUD officials reviewed the reasons why all of the initial loans were not reviewed for this lender and stated that CHUMS had counted some loans for the 100 percent PETR phase that had already been reviewed as test cases in the preclosing phase. Also, the Homeownership Center official likely did not enter the date of unconditional authority into CHUMS until 11 days after the authority had been granted. Therefore, loans were only selected for review after the date was entered into CHUMS. In addition, the Homeownership Center did not review one loan that was selected by CHUMS.

HUD Was Taking Corrective Action

HUD had already modified CHUMS to address one of the reasons why initial loans were not reviewed for the 100 percent PETR phase. During the audit, HUD modified or started the process to modify CHUMS to resolve the other issues that were identified.

- On May 3, 2010, the system was modified to prevent Homeownership Center officials from removing cases from the list to be reviewed.

- On January 28, 2011, the system was modified to prevent the selection of cases that were reviewed for the preclosing phase from counting toward the 100 percent PETR phase.

- The system will be modified to require Homeownership Center officials to enter the current date as the date of unconditional authority.

- The system will be modified to select cases based on the underwriting lender (retail, sponsor, authorized agent). Currently, the system selects the underwriting lender in a retail and sponsor transaction but selects the originator in a principal/authorized agent transaction.

These corrective actions should strengthen HUD's monitoring of its newly approved lenders.

The Homeownership Centers Used Reports That Were Insufficient

All of the Homeownership Centers tracked and monitored newly approved lenders for the 100 percent PETR phase; however, some of them used reports that were not sufficient to properly monitor the lenders. Officials at the Atlanta Homeownership Center used reports obtained from Neighborhood Watch that only listed loans originated by the lender under review. Therefore, these reports did not contain loans that had been underwritten by the lender under review but were originated by other lenders. Also, these reports did not identify whether loans that had initially been rated unacceptable were later mitigated. In addition, the reports from FHA Connection that were used by the Denver and Philadelphia Homeownership Centers did not contain loans that were in other jurisdictions. For example, lenders that had a home office in the Denver Homeownership Center jurisdiction may also have had a branch office that underwrote loans in another Homeownership Center's jurisdiction.

HUD officials stated there was no single report that provided all of the information necessary to properly monitor newly approved lenders for the 100 percent PETR phase. During the audit, HUD officials acknowledged that the method of tracking lenders for the 100 percent PETR phase needed improvement and stated that they were working to create a report for the Homeownership Centers to use that would contain all of the required information.

Other Issues Were Noted

One lender was inappropriately returned to preclosing status, and another lender with unacceptable performance was not returned.

- The lender file for one lender showed that HUD granted it unconditional authority on August 28, 2009, and returned it to preclosing status on May 24, 2010, because 9 of 27 loans reviewed for the 100 percent PETR phase were rated unacceptable. The requirements state if the lender's performance is unacceptable (i.e., 20 percent of the files are rated unacceptable) under the 100 percent PETR phase, the lender will be returned to preclosing status. We reviewed the lender file maintained by the Homeownership Center and determined that a report listing all of the loans included in the 100 percent PETR phase showed that the total number of loans reviewed was 20, with only 3 rated unacceptable. When loans were rated unacceptable and, upon HUD's review, were changed to mitigated, this report listed the same loan multiple times. Apparently Homeownership Center officials mistakenly counted the duplicates as separate loans. Since the lender only had 3 of 20 unique loans that were rated unacceptable, it should not have been returned to preclosing status.

- The tracking report maintained in the lender file showed that another lender had an unacceptable performance for the 100 percent PETR phase; however, the Homeownership Center did not perform additional follow-up with the lender. Officials had incorrectly determined that this lender's performance was acceptable for the 100 percent PETR because they had mistakenly counted loans that were sponsored by other lenders. If these loans had been omitted as they should have been, the lender's performance would have been unacceptable for the 100 percent PETR phase. Therefore, Homeownership Center officials should have continued to monitor this lender to determine whether either of the loans rated unacceptable was later mitigated or whether the lender should have been returned to preclosing status.

The Homeownership Centers continually monitored the performance of all FHA direct endorsement lenders, including the newly approved lenders, under HUD's regular PETR program. However, by failing to review approximately half of the initial loans endorsed by newly approved lenders as required, HUD did not provide the oversight intended under its 100 percent PETR requirement for newly approved lenders.

Conclusion

Although HUD addressed the issues reported by GAO in 2004 by making changes to CHUMS and FHA Connection to ensure that the initial loans endorsed by newly approved lenders were reviewed, the Homeownership Centers continued to review significantly less than the required 100 percent. This condition occurred because CHUMS was not programmed to properly to select all of the required loans. The Homeownership Centers relied upon the system to select all of the required initial loans for review, and, therefore, loans skipped by the CHUMS program were not reviewed. Also, there was no single report that contained all of the necessary information for the Homeownership Centers to use in monitoring newly approved lenders for the 100 percent PETR phase. As a result, Homeownership Centers did not provide the underwriting oversight for newly approved lenders as intended by the 100 percent PETR phase.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

2A. Establish controls to ensure that the required number of initial cases endorsed by newly approved lenders is selected to be reviewed for the 100 percent PETR phase.

2B. Establish a report to be used by the Homeownership Centers that contains all of the required information necessary to properly monitor the performance of newly approved lenders in the 100 percent PETR phase.

SCOPE AND METHODOLOGY

We performed an audit of HUD's preclosing and postclosing reviews of new direct endorsement lenders. Our audit period covered lenders that entered and completed the preclosing phase from July 1, 2008, to June 30, 2010. We conducted our fieldwork at the Atlanta, Denver, Philadelphia, and Santa Ana Homeownership Centers from August to December 2010.

The Homeownership Centers provided a list of lenders that entered the preclosing phase from July 1, 2008, to June 30, 2010. The list identified which lenders also completed the preclosing phase during this timeframe. There were 287 lenders that entered and completed the preclosing phase within our audit scope.

Homeownership Centers	Lenders that entered	Lenders that completed	Lenders that were suspended /terminated	Lenders still in preclosing
Atlanta	163	89	9	65
Denver	86	36	10	40
Philadelphia	198	100	25	73
Santa Ana	132	62	32	38
Total	**579**	**287**	**76**	**216**

Our initial survey scope focused only on HUD's preclosing phase; however, based on the survey results, we expanded our audit scope to include the 100 percent PETR phase. Our audit scope did not include an evaluation of the quality of underwriting reviews performed by Homeownership Center officials. For the preclosing phase, we reviewed the Homeownership Center files for lenders participating in the preclosing review phase (lender files). We randomly selected a nonstatistical sample of 40 lenders that entered and completed the preclosing phase from July 1, 2008, to June 30, 2010, at each Homeownership Center[9]. Because the Denver Homeownership Center only had 36 lenders that entered and completed the preclosing phase in our audit scope, we reviewed a total of 155 lender files. We did not conduct any performance reviews for the lenders selected in our sample.

For the 100 percent PETR phase, we reviewed the 36 lenders at the Denver Homeownership Center in addition to a randomly selected nonstatistical sample of 30 lenders at each of the remaining Homeownership Centers. The lenders were selected based on the list of lenders provided by the Homeownership Centers that entered and completed the preclosing phase from July 1, 2008, to June 30, 2010. In total, we reviewed 125 lenders for the 100 percent PETR phase.

To estimate the number of initial loans endorsed by newly approved lenders that did not undergo a PETR, we randomly selected a nonstatistical sample of 25 lenders from the universe of 125.

[9] One lender that was selected in our nonstatistical sample for the Santa Ana Homeownership was returned to preclosing status due to not paying the upfront mortgage insurance premiums. Therefore, we did not review this lender for the preclosing or the 100 percent PETR requirements.

To accomplish our objective, we

- Reviewed the prior GAO report relating to HUD's preclosing and postclosing phases,
- Reviewed HUD's guidance for the preclosing and postclosing phases,
- Reviewed the tracking logs and underwriting reports contained in the lender files for lenders in the preclosing phase,
- Reviewed PETR reports used by the Homeownership Centers for lenders in the 100 percent PETR phase,
- Interviewed Homeownership Center officials to determine the process for the preclosing and postclosing phases, and
- Interviewed HUD headquarters officials to determine the process for the 100 percent PETR phase.

We used computer-processed data maintained by HUD in its information systems for FHA loans (Neighborhood Watch) to obtain the list of loans endorsed by newly approved lenders to determine whether all of the required initial loans were reviewed. The data were supported by reports that were used by the Homeownership Centers to determine the loans reviewed for the 100 percent PETR phase. We considered the data to be sufficiently reliable for our purpose.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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 objectives:

- Program operations – Policies and procedures that management has implemented to reasonably ensure that the program meets it objective.

- Compliance with applicable laws and regulations – Compliance with applicable internal and regulatory requirements.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

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

- HUD did not have effective controls in place to ensure that lenders were granted unconditional authority in accordance with its requirements for the preclosing phase.
- HUD did not have controls in place to ensure that PETRs were performed on all of the initial loans submitted by newly approved lenders.

APPENDIX

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

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

OFFICE OF HOUSING

APR 1 1 2011

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

FROM: Vicki B. Bott, Deputy Assistant Secretary for Single Family Housing, HU

SUBJECT: Discussion Draft Report
HUD Did Not Always Follow its Requirements for the Pre-closing and Post-closing Review of Mortgage Files Submitted by New Direct Endorsement Lenders

This is in response to your memorandum dated March 10, 2011, transmitting the subject draft audit report. We are providing formal comments to the draft for your consideration.

The Office of the Inspector General (OIG) audited the U. S. Department of Housing and Urban Development's (HUD or the Department) pre-closing and post-closing loan review of new Federal Housing Administration (FHA) lenders. This audit followed up on selected findings in the Government Accountability Office's (GAO) November 2004 audit report on HUD's oversight of FHA lenders. The audit objectives were to determine whether HUD followed GAO's guidance when (1) reviewing the initial loans (test cases) underwritten by new FHA direct endorsement (DE) lenders and (2) performing the post-endorsement technical review of all of the initial loans endorsed by newly approved DE lenders.

Pre-closing Review

Comment 1

OIG determined that although improvements had been made since the November 2004 GAO audit (which observed a 14.3 percent non-compliance rate), HUD granted unconditional DE authority to 4.5 percent (7 of 155 lenders OIG reviewed) of the new FHA DE lenders that did not successfully complete HUD's pre-closing requirements. These 7 lenders generally submitted 15 or more test cases; however, some of the cases did not count towards the test case process because they were sponsored (underwritten) by another DE lender, or because there was an insufficient mix of manually underwritten cases. On March 25, 2009, the Office of Single Family Housing (Housing) decreased the required number of manually underwritten cases from 10 to 5, with the additional 10 test cases permitted to be a combination of automated underwriting and a maximum of 2 streamline refinance loans. OIG cites 3 lenders for failing to meet the required minimum 10 manually underwritten loans. Housing granted these 3 DE lenders unconditional authority shortly before it issued its reduced manually underwritten file requirements. Because Housing Headquarters and Homeownerships Centers (HOC) develop new requirements jointly and each of the 3 DE lenders completed a minimum of 5 manually underwritten test cases, it is certainly conceivable that the reduced review of manually underwritten cases for each of these three lenders was the result of an anticipated release of revised guidance.

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The OIG states that since DE lenders with unconditional authority underwrite and close mortgage loans without FHA review or prior approval, there may be increased risk to the FHA insurance fund for the seven lenders that were approved for unconditional authority without fully demonstrating that they could successfully underwrite loans in accordance with FHA requirements. OIG goes on to state that in 2010, these lenders endorsed 1,408 FHA loans with mortgages totaling $276.2 million.

Comment 2

While Housing appreciates the OIG's concern, it disagrees that there "may be increased risk to the FHA insurance fund for the seven lenders that were approved..." as stated by the OIG. For all seven DE lenders, the selection and mix of test cases was sufficient to ensure confidence that the lender would continue to underwrite loans according to FHA guidelines. Housing evaluated the performance of six of the seven DE lenders for the two year period ending February 28, 2011.[1] All six DE lenders' seriously delinquent and claim rates were significantly below the average U.S. rate; and in all cases except one, the rate was less than half of the average U.S. rate, indicating that these six DE lenders have not put the FHA insurance fund at risk.

Further, Housing has maintained a proactive approach of identifying high risk DE lenders and initiating counterparty risk activities to minimize losses to the FHA insurance fund. In January of 2010, Housing extended its regulatory enforcement authority under the Credit Watch Termination Initiative to DE lenders. Under this authority, Housing will systematically review all DE underwriting lenders' defaults (loans delinquent 90 or more days) and claim rates on loans during the initial 24 months from the date of the commencement of the amortization. Housing, at its option, will exercise its authority to terminate the underwriting authority of DE lenders with excessive default and claim rates in specific field office jurisdictions. During 2010, Housing terminated the DE authority of 19 lenders in specific field office jurisdictions.

Finally, Housing generally agrees that a more consistent approach to tracking lenders and test cases during the pre-closing process would provide more consistent reports for enhanced oversight of DE lenders.

<u>Post Endorsement Technical Review (100 percent) Phase</u>

OIG determined that although improvements had been made in Housing's loan activity tracking system[2] since the November 2004 GAO audit (which observed a 7 percent loan review rate), the review rate only increased to approximately 50 percent of the required number of loans after unconditional DE authority was granted.[3] Housing requires a lender to undergo a 100 percent loan review phase upon granting unconditional DE authority. OIG determined that some of the initial loans were skipped and/or the required number of initial loans (30 or 10) did not undergo a post endorsement technical review as required.

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[1] The evaluation was completed using FHA's Single Family Neighborhood Watch direct endorsement lender seriously delinquent and claim performance measures for the 2-year period ending February 28, 2011. The seventh lender was granted Home Equity Conversion Mortgage unconditional authority; and has acted in the direct endorsement capacity on 9 loans, none of which have been assigned to HUD or been subject to a claim submission.

[2] The Underwriting Review System is a subset of the Computer Home Underwriting Management System and FHA Connection.

[3] On February 15, 2010, Housing reduced the number of loans required to be reviewed after a lender was granted DE unconditional authority from 30 to 10.

During the audit process, and subsequently, Housing worked with the OIG to determine the reasons that the activity tracking system was not selecting cases as required. Housing has completed the necessary modifications to the workload tracking system to resolve the case selection issues.

- On May 3, 2010, the system was modified to prevent HOC (and contractor) staff from deselecting cases from the list to be reviewed.
- On January 28, 2011, the system was modified to prevent the selection of cases that were reviewed during the pre-closing phase (but endorsed after DE unconditional authority was granted) from counting toward the 100 percent review phase.
- On March 17, 2011, the system was modified to require HOC staff to enter the current date as the date unconditional DE authority was granted.
- On March 31, 2011, the system was modified to select cases based on the underwriting lender (retail, sponsor, authorized agent).

Housing is confident that the implemented system controls will ensure that all loans required to receive a post-endorsement technical review during the 100 percent phase will be reviewed. Housing is in the process of developing a comprehensive report for use by all HOCs and Housing management to monitor newly approved lenders during the required 100 percent post-endorsement technical review phase.

Comment 3
Comment 4

While Housing appreciates OIG's concerns surrounding the required 100 percent review phase, Housing does not agree that its monitoring of newly approved DE lenders' performance was "weakened," and the amount of the increased risk these lenders pose to the FHA insurance fund is "uncertain." Housing's pre-closing process includes the appropriate selection and mix of test cases sufficient to ensure confidence that DE lenders continue to underwrite loans according to FHA guidelines upon receiving unconditional DE authority. Housing evaluated the performance of each of the 27 DE lenders noted in Recommendation 2 for the two year period ending February 28, 2011.[4] All 27 DE lenders' seriously delinquent and claim rates were below the termination threshold set by HUD's Credit Watch Termination initiative for DE lenders. More significantly, 23 of these DE lenders have a rate that is less than half of the average U.S. rate, indicating that these DE lenders have not put the FHA insurance fund at risk.

In addition, Housing implemented significant changes to its post endorsement technical review process as part of its Single Family Loan Review Initiative during FY 2010. There are several major accomplishments that enhance Housing's monitoring of DE lenders and reduce risks to the FHA insurance fund. Among its most notable accomplishments, Housing:

- Modified the post endorsement loan review selection criteria to eliminate dependence on loan volume;
- Began selecting loans at endorsement for post endorsement technical review using a risk based rules algorithm for forward and reverse mortgages in May 2010;

[4] The evaluation was completed using FHA's Single Family Neighborhood Watch direct endorsement lender seriously delinquent and claim performance measures for the 2-year period ending February 28, 2011.

Comment 5

- Implemented an additional post endorsement technical review selection criteria in June 2010 that selects all early payment default cases for loan level technical review;
- Standardized the post endorsement technical review and Underwriting Reporting System data entry procedures across all four HOCs;
- Established consistent deficiency codes and unacceptable ratings for the post endorsement technical review process; and
- Standardized the loan level review methods at the HOCs through the issuance of a draft guide.

Further, Housing also believes that the implementation of its regulatory authority under the Credit Watch Termination Initiative for DE lenders, as well as the robust lender monitoring of DE lenders by HUD's Quality Assurance Division, provide the additional monitoring tools necessary to create a sufficiently strong oversight environment.

Conclusion

Housing's current pre-closing process provides substantive analysis of a DE lender's ability to underwrite loans in accordance with FHA guidelines. The 100 percent post endorsement technical review phase is a minor piece of Housing's current loan and lender review processes, subsequent to the granting of unconditional DE authority by FHA. With the addition of a risk based rules algorithm implemented at endorsement, and the review of all early payment defaults during the post endorsement technical review process, it is questionable if the 100 percent review phase is still a necessary oversight tool. As indicated earlier, Housing will take the necessary steps to ensure system controls and reporting tools are in place to provide HOCs and Housing management with a consistent view of a DE lender's pre-closing and post-closing status. Housing shares the OIG's ongoing interest in ensuring the robustness of HUD's monitoring and oversight mechanisms for FHA programs. The Department is confident that its continued efforts to strengthen and effectively implement the risk management tools at its disposal have yielded significant improvements that permit HUD to satisfactorily protect its insurance funds.

OIG Evaluation of Auditee Comments

Comment 1 We agree with the auditee's response that it is conceivable that the reduced review of manually underwritten cases for three lenders was the result of an anticipated release of revised guidance. However, the OIG reviewed these lenders based on the guidance that was effective at the time they were granted unconditional authority.

Comment 2 We acknowledge the auditee's response that the seven lenders which were improperly approved for direct endorsement authority have not put the FHA insurance fund at risk; however, it is impossible to know if future applicants for direct endorsement authority will be similarly qualified. We believe there is increased risk in the future if HUD continues to grant unconditional authority to lenders that do not successfully complete the minimum test case requirements, because FHA will be committed to insure their loans whether or not the lenders demonstrated their capacity to comply with FHA underwriting requirements. The report has been modified to reflect this.

Comment 3 We disagree with the auditee's response that the monitoring of newly approved lenders' performance was not weakened. While the preclosing phase does review various types of test cases to ensure that lenders underwrite loans in accordance with FHA requirements, the 100 percent PETR phase provided an additional level of assurance that newly approved lenders would continue to follow the requirements. The auditee's response notes several major accomplishments that enhance the monitoring of newly approved lenders; however, these occurred at the end of our audit scope.

Comment 4 We acknowledge the auditee's response that the lenders under finding 2 did not pose uncertain risk to the FHA insurance fund. We deleted this language from the report.

Comment 5 We acknowledge the auditee's response that they question whether the 100 percent PETR phase is still a necessary oversight tool based on enhanced monitoring tools they implemented.However, we did not review the new monitoring tools, and cannot conclude on the continued utility of the 100 percent PETR phase.