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

*Joan S. Hobbs*

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: HUD's Controls over the Single Family Preforeclosure Sale Program and Preforeclosure Sale Claims Need Improvement

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited the U.S. Department of Housing and Urban Development's (HUD) preforeclosure sale program after investigators from HUD's Office of Inspector General (OIG) identified instances of program abuse regarding several Federal Housing Administration preforeclosure sales to investors. The objectives of the audit were to (1) determine what abuses occurred within the preforeclosure sale program and how they impacted losses to the Federal Housing Administration insurance fund and (2) evaluate HUD's controls over preforeclosure sales and preforeclosure sale claim processing.

### **What We Found**

Investors abused the HUD preforeclosure sale program and obtained properties through preforeclosure sales below fair market value contrary to HUD requirements. Based upon limited testing, we identified 102 properties that were sold through preforeclosure for at least \$2.4 million less than their fair market value, resulting in excessive insurance claims to HUD. Additionally, HUD's

claims processing system allowed for payment of at least 52 preforeclosure sale claims that were excessive by amounts totaling approximately \$5.1 million. These claims did not meet HUD's requirements for minimum net preforeclosure sale proceeds and/or minimum property appraised values. We attributed these conditions to inadequate controls over the preforeclosure sale program, especially in relation to controls over the appraisal and marketing process for the properties involved in the program, and inadequate controls within the claim payment system.

### **What We Recommend**

We recommended that HUD's assistant secretary for housing - federal housing commissioner implement controls to minimize abuse of the preforeclosure sale program and to ensure excessive preforeclosure sale claims are not paid.

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 report.

### **Auditee's Response**

We provided HUD a draft audit report on July 13, 2005, and held an exit conference to discuss the report on August 11, 2005. At the exit conference, HUD did not dispute the facts cited in the report and agreed weaknesses within the preforeclosure sale program should be corrected to prevent program abuse by investors and to prevent payment of excessive claims. HUD stated they would perform further review of the preforeclosure program to identify additional instances of program abuse and evaluate which of the audit report recommendations (or other corrective actions) will be most appropriate for correcting control weaknesses cited in the audit report. HUD's formal written comments were due by August 25, 2005, however, comments were not received by OIG prior to the issuance of this audit report.

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## BACKGROUND AND OBJECTIVES

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The U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration provides mortgage insurance on home loans made by its approved lenders. This insurance provides lenders with protection against losses if the homeowner defaults on the loan. Lenders can submit an insurance claim to HUD for losses incurred if the property is foreclosed upon; however, the lender must first attempt to work with the homeowner and consider options available as part of HUD's loss mitigation program, which can assist the borrower to bring the loan current or allow the borrower to dispose of the home without foreclosure. HUD's single family preforeclosure sale program is one option under HUD's loss mitigation program.

The preforeclosure sale program was implemented in 1994 as an alternative to foreclosure for borrowers who can no longer afford their home but cannot sell it because the fair market value of the property has declined to less than the amount owed on the mortgage. In such a case, the eligible borrower is allowed to sell the property for less than the unpaid mortgage balance, and the lender can submit a claim to HUD for the difference between the proceeds received from the sale and the amount owed on the mortgage (plus interest and other costs). The borrower and lender each receive a \$1,000 incentive for participating in the program. HUD will also effectively pay \$1,000 to discharge any other liens that may exist on the property. By avoiding foreclosure and the associated costs for maintaining and reselling the property after it is conveyed to HUD, effective use of the preforeclosure sales can reduce HUD's losses on certain insurance claims. Preforeclosure sales can also be preferable to HUD borrowers since the effect on the borrower's credit report is less detrimental than a foreclosure. Preforeclosure sales can also benefit the neighborhoods where the properties are located because properties are sold more quickly than under foreclosure and are, therefore, vacant for a shorter period.

HUD limits participation in the preforeclosure program to borrowers who meet certain requirements and have experienced a legitimate financial hardship that resulted in their loan default. HUD has other key requirements for participation including the following:

1. The lender must obtain an appraisal of the involved property, and this appraised value must be at least 63 percent of the unpaid mortgage balance.
2. The net proceeds received from the preforeclosure sale (to be used for satisfaction of the mortgage) must equal at least 82 percent of the property's appraised value.

Although HUD sets these minimum requirements for the appraised value and net sales proceeds for a property to be considered for the program, it requires that properties be sold at fair market value. HUD Mortgagee Letter 94-45 states that preforeclosure sales must be characterized by a selling price and other conditions that would prevail in an open market environment.

HUD's losses on preforeclosure sales are on average less than foreclosure losses. According to data received from HUD, in fiscal year 2004, HUD paid 5,266 preforeclosure claims totaling approximately \$128.5 million. For fiscal year 2004, the average preforeclosure claim amount of

\$24,400 was \$3,974 less than the average loss amount for foreclosure claims during this same period. Therefore, preforeclosure sales theoretically resulted in a savings to HUD of \$20.9 million in fiscal year 2004 (\$3,974 average lower claim amount times 5,266 preforeclosure sales). Similarly, the savings for fiscal year 2003 was \$14.2 million.<sup>1</sup> However, since HUD only accepts properties for participation in the program if they have limited damage, are not abandoned, and meet resale value requirements, some of the program's theoretical savings may be the result of limiting participation to higher quality properties and not the result of benefits achieved by the program itself.

The number of annual preforeclosure sales has been increasing. From 2001 to 2004, the number of preforeclosure cases increased by 80 percent while foreclosures increased by only 18 percent. This increase in use was likely due to program changes made in 2000, which expanded the number of HUD-insured properties that could qualify for the program. HUD is currently considering additional program changes including relaxed requirements for participation in the program. If enacted, these changes would likely further increase the number of preforeclosure sales.

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<sup>1</sup> Calculation of estimated savings assumes all preforeclosure sales would have otherwise resulted in foreclosure and the difference between preforeclosure claim amounts and foreclosure loss amounts resulted from factors attributable to the preforeclosure sale program such as reduced maintenance, marketing, and repair costs.

## RESULTS OF AUDIT

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### Finding 1: HUD's Controls over Preforeclosure Sales Are Not Adequate to Prevent Program Abuse

Investors abused HUD's preforeclosure sale program and obtained properties below fair market value contrary to HUD requirements. This resulted in excessive claims to HUD's Federal Housing Administration insurance fund. Based upon limited testing, we identified 102 insured properties that were sold through preforeclosure to investors and then resold almost immediately at an increased sales price (profit), indicating these preforeclosure sales occurred at less than fair market value. The increased sales price on these "flip" sales totaled \$2.4 million or nearly \$24,000 per property. In many of the flip sale transactions identified, the property appraisals used were undervalued, marketing was not attempted, and the borrowers were not properly informed about the program's requirements and HUD's available home retention options. HUD needs to strengthen its controls over these areas of the preforeclosure sale program to limit its risk of losses due to program abuse by investors.

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#### **Investors Abused the Preforeclosure Sale Program**

While the preforeclosure sale program was intended to provide Federal Housing Administration insurance proceeds to cover the gap between a property's unpaid mortgage balance and its fair market value, in many cases, the insurance proceeds were effectively used to fund a discount on the preforeclosure sales price for the benefit of purchasing investors. We reviewed public real property records and HUD's automated data related to 209 preforeclosure sales to investors for properties located in Arizona, Texas, Utah, and Nevada. Lender file documentation such as the appraisal was available for our review in 133 of these cases. We found that at least 102 of the 209 preforeclosure sales to investors occurred at prices significantly less than the fair market value. After purchasing the properties at this reduced price, the investors quickly resold the properties at their greater, apparent fair market value. Ninety-five of these properties were resold on the same day the preforeclosure sale occurred, and the remaining seven were resold within one week. The increased sales price on these flip sales totaled \$2.4 million or nearly \$24,000 per property.<sup>2</sup> Since these properties were sold through preforeclosure sales at less than fair market value, the sales generated less money to pay off the outstanding mortgage balances, and the associated insurance claims were larger than necessary.

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<sup>2</sup> The 102 cases of investor abuse were identified based upon limited testing of preforeclosure sales that occurred primarily within three states (Arizona, Texas, and Utah). Therefore, the impact of investor abuses nationwide may be much greater.

It appears the involved investors took measures to bypass open marketing of the properties and HUD's program requirements. In many of the flip sale transactions identified, the property appraisals used were undervalued, the properties were not marketed, and the borrowers were not informed of the program requirements and other available alternatives to foreclosure as required. These factors assisted the investors in purchasing preforeclosure properties for less than fair market value. For example,

- Lenders relied upon undervalued appraisals that were obtained based upon inaccurate or inappropriate comparable sales data. For a typical HUD property appraisal, the appraiser selects recent property sales in the area of the subject property and relies upon data from these transactions, including the sales price, to establish an estimated value for the subject property. However, in 45 of the 133 preforeclosure sales transactions we reviewed for which lender file documentation was available, the appraisal showed an incorrect sales price for one or more comparable properties or ignored the most recent sale and used a lower valued prior sale. Also, in 10 cases, the appraisals inappropriately relied upon "distress sale" comparable properties. By definition, a distress sale occurs at less than fair market value and, therefore, should not be used to establish the fair market value for a preforeclosure sale. Finally, in many cases in which the comparables were accurately priced, the appraiser made large, unsupported downward value adjustments to reduce the preforeclosure sale property's appraised value.
- Properties were often never marketed to ensure that a fair and reasonable sales price was obtained. Instead, the investors involved contacted the borrowers directly and arranged to purchase the properties through the preforeclosure sale program without open marketing. In 51 cases, false listing agreements were included in the lenders' files, apparently intended to disguise the fact that no marketing occurred. The investors likely identified the borrowers in default by reviewing the notices of trustee sale that lenders normally file with the county recorder when a mortgage loan is several months in default. Since the minimum sales price allowable under the preforeclosure program is publicly available information, the investors knew the minimum sale price allowable under HUD's preforeclosure program and were, therefore, able to pursue the lowest possible sale price without open market competition. In some cases, the borrowers were apparently offered an unallowable "kickback" payment as an inducement to sell the property to the investor at the contracted (reduced) price.
- Borrowers were unaware of program requirements and other loss mitigation options. In at least 87 cases, borrowers did not receive loss mitigation counseling as required. In these cases, the lenders' files

contained falsified certifications that counseling was completed. If the borrowers in these cases had been properly informed of the program requirements and other available options that would allow them to retain their home, the preforeclosure sale at less than fair market value may have been avoided. In addition, nine cases were identified with apparently false “hardship letters” used to characterize the borrowers’ financial situation and justify the borrowers’ participation in the program. The use of falsified documents to facilitate the sale further illustrates that the involved parties intended to bypass HUD’s program requirements to obtain properties below market value.

In many of the 102 cases in which properties were resold within one week by investors, the preforeclosure sale likely could have been avoided. For example, in 20 of the 102 cases in which the property was resold within one week, the increase in sales price from the preforeclosure sale to the resale by the investor was greater than the total claim amount to HUD. Therefore, the borrowers in these cases could have likely sold the property at fair market value with no resultant insurance claim to HUD and associated damage to the borrowers’ credit record.

### **HUD’s Program Controls Are Not Adequate**

Program abuse by investors occurred and went undetected because HUD’s controls over the preforeclosure sale program are not adequate. At the inception of the program, HUD staff was involved in reviewing and approving individual preforeclosure sale transactions. Now the servicing lenders are responsible for overseeing the entire preforeclosure sale transaction. Although HUD transferred most responsibility to the servicing lenders to oversee the transactions, it did not make adequate changes to the program’s control procedures to allow for sufficient oversight of the lenders administering the program. For example, although HUD staff was once required to review property appraisals and ensure there was specific justification for a large decrease in a property’s appraised value, no similar requirement was enacted for lenders. Rather, HUD currently only requires that the lender review the appraisal and does not provide specific requirements for the substance of these reviews. As a result, the lenders’ reviews of the appraisals have often been superficial. Further, there are no requirements for the lenders to ensure that appropriate market exposure is obtained to increase the likelihood that a fair market price will be received for the properties.

HUD has some limited controls over preforeclosure sales; however, these are not sufficient to prevent program abuse by investors. Current controls include automated error checking on claim form data submitted by the lender, postclaim lender file reviews performed by a contractor, and lender monitoring reviews

performed by HUD's Quality Assurance Division. These reviews were not effective in preventing program abuse by investors for the following reasons:

- HUD's preclaim automated reviews only check for items such as correct servicer identification numbers, correct loan balance information, and whether HUD insurance is active on the loan. These automated error checks are applicable to all claims and, therefore, do not relate specifically to the preforeclosure program requirements (also see finding 2).
- HUD's postclaim contractor reviews only test to determine whether information submitted on the claim form is accurate and not whether preforeclosure program requirements have been met. In addition, the postclaim review methodology is not likely to select a sufficient number of preforeclosure claims to identify patterns or trends of noncompliance with preforeclosure requirements. For example, the contractor's review of Chase Manhattan Mortgage in 2004 included a sample of 147 cases, of which only one was a preforeclosure claim, with no errors identified. Neither the contract for the performance of these reviews nor the checklists used by the contractor during the reviews specify preforeclosure program requirements that should be checked. These reviews are not designed to detect potential program abuse by investors or to identify sales that occurred at less than fair market value. Accordingly, the reviews do not serve as an effective control over the program.
- HUD's Quality Assurance Division servicing reviews are limited to loans currently being serviced and do not include preforeclosure sales that have already resulted in a claim. As a result, any review of the preforeclosure sale program is limited to cases being processed at the time of the review. Cases for which the sales process has been completed would not be selected for review. Also, the Quality Assurance Division selects its sample files by lender and never targets a type of loan file. Because loans in preforeclosure represent only a small portion of a lender's total loans, the Quality Assurance Division is not likely to select more than a few in-process preforeclosure files for review, and, therefore, its reviews are not effective in identifying patterns of investor abuse.

**HUD Does Not Review Preforeclosure Sale Appraisals or Ensure Properties Have Been Marketed**

Additionally, none of HUD's controls (preclaim, postclaim, or quality assurance) include a review of the appraisal to determine whether it is accurate and represents a reasonable fair market value for the property. This is a key aspect of the preforeclosure program since the value set by the appraisal will determine the

minimum selling price for the property and ultimately may affect the loss amount to HUD. If an undervalued appraisal is obtained, the property may be sold for much less than its fair market value. For example, if a property with a \$150,000 loan balance is appraised at \$95,000 while the fair market value is \$145,000, HUD's loss could be excessive by at least \$41,000 ( $\$145,000 \times 82$  percent less  $\$95,000 \times 82$  percent) on this single property. Because of the potentially large profits that can be achieved in this manner, the program is particularly susceptible to abuse by investors. Since in many cases, it appears investors arrange for a low sales price by directly contacting the borrower and the properties are not actively listed and marketed, the low sales price may unduly influence the final appraisal value and result in an undervalued property.

Further, HUD's controls do not include a review to ensure properties have been marketed to achieve a fair market value sales price. HUD does not require properties be marketed in cases in which a buyer has already been located. Accordingly, investors are able to contact borrowers directly and establish a sales price without open market competition. The investors in this circumstance could pursue the minimum allowable sales price under the program. Since the parties involved in selling the property (the borrower and lender) do not receive an additional incentive based upon a higher sales price and there is effectively no competition for the purchasing investor, the sales price is not set within open, fair market conditions. As a result, properties are sold to investors at less than fair market value.

## Conclusion

Weaknesses in HUD's controls allowed investors to abuse the preforeclosure sale program and obtain properties below market value contrary to HUD's program requirements. We found 102 properties that were sold through HUD preforeclosure sales for a total of \$2.4 million less than their fair market value. As a result, HUD paid excessive insurance claims on these cases. On these preforeclosure sales to investors, the intended benefits of the preforeclosure sale program to assist homeowners and reduce HUD's losses were not achieved. Rather, the program benefited the involved investors who effectively used the program to achieve substantial gains on property-flipping transactions. HUD needs to strengthen its controls over preforeclosure sales to identify potential program abuses and prevent excessive claims. This would include reinforcing controls over the appraisal process, implementing procedures to encourage full market exposure of the properties, and emphasizing lenders' responsibility to ensure that borrowers are made fully aware of preforeclosure program requirements and of their options under the loss mitigation program.

## Recommendations

We recommend that the assistant secretary for housing - federal housing commissioner

1A. Contract for review of preforeclosure sale appraisals. Contracts could provide for payment by commission only based upon errors identified. Alternatively, HUD could review a targeted sample of appraisals for preforeclosure sales. Appraisal reviews could be targeted based upon risk factors that would indicate potential undervaluation such as a large difference between the appraised value and the prior sales price. These reviews should include verification of comparable sales data and a determination as to the appropriateness of selected comparable sales.

1B. Implement specific requirements for lenders' review of appraisals. For example, HUD could require lenders to provide and document specific justification for a decrease in appraised value by 25 percent or more from the prior sales price or a decrease of 15 percent or more when the appraisal states property values have been increasing in the area of the subject property. Lenders should also be required to certify that comparable sales were reviewed and found to be appropriate.

1C. Prohibit the use of "distress sales" for appraisal comparable sales on preforeclosure cases.

1D. Require lenders to verify directly with the counseling provider that the borrower received housing counseling.

1E. Require lenders to speak directly with the borrower and determine a) whether the borrower received housing counseling and is aware of HUD's loss mitigation options that allow borrowers to retain their homes, b) whether the borrower is aware of preforeclosure program requirements and the implications of participating in the preforeclosure program, and c) what agreements or arrangements were made with the buyer or realtor.

1F. Limit the risk of excessive losses due to program abuse by investors by implementing additional program restrictions for preforeclosure sales in which 1) a public notice of trustee sale has been filed and 2) the buyer is a nonowner occupant. For example, HUD could raise the required appraisal value and net sales proceeds ratios for such cases beyond the current requirements.

1G. Track preforeclosure sale purchasers and review transactions for investors purchasing a large number of properties.

1H. Consider basing a portion of the lender's incentive on the amount of net proceeds recovered from the sale. For example, if the net proceeds are greater than 70 percent of the unpaid balance, an additional incentive could be paid.

1I. Establish restrictions to prohibit any sale at less than the appraised value unless the property has been marketed in the Multiple Listing Service for an established period with no qualifying offers submitted. Require Federal Housing Administration borrowers and involved realtors to certify that marketing was performed and that the best available qualifying offer was accepted.

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## Finding 2: HUD's Controls Are Not Adequate to Prevent Payment of Excessive Preforeclosure Sale Claims

HUD paid at least 52 excessive insurance claims during the period October 1, 2001, through January 31, 2005, related to preforeclosure sales for amounts totaling approximately \$5.1 million. In 42 of these cases, the involved lenders self-identified the overpayment and refunded the excessive amounts to HUD. In the remaining 10 cases, the lenders did not report the overpayment, and the excessive amounts have not been refunded to HUD. These overpayments went undetected by HUD because it does not have adequate controls within its claim payment system to identify and prevent payment of preforeclosure claims that do not meet HUD's minimum requirements.

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After a Federal Housing Administration preforeclosure property sale is completed, lenders can submit a claim to HUD for Federal Housing Administration mortgage insurance benefits to recover the difference between the net sales proceeds (the amount recovered from the property sale) and the unpaid balance on the mortgage loan. The insurance claim amount includes an incentive payment due the lender and other loan-related costs allowable by HUD. Nearly all preforeclosure claims are submitted electronically by the lender to HUD's Claims Branch at HUD Headquarters. Once a claim is received, HUD's computer system performs a series of "edit checks" on the claim data submitted by the lender to determine whether the claim is eligible for immediate payment or whether further information is necessary to determine the claim's eligibility or amount.

### **HUD's Controls Over Automated Preforeclosure Claim Payments Are Not Adequate**

We found HUD's controls over preforeclosure sale claim payments were not effective in preventing certain excessive claims. HUD inappropriately paid at least 52 preforeclosure claims during the period October 1, 2001, through January 1, 2005, that were excessive by amounts totaling approximately \$5.1 million. In 42 of these cases, the lenders self-identified the overpayments and refunded the excessive amounts to HUD. In the remaining 10 cases, the lenders did not report the overpayment, and the excessive amounts have not been refunded to HUD. In one of these 10 cases, the lender erroneously submitted a preforeclosure claim that should have been submitted as a conveyance (foreclosure) claim.

HUD paid the excessive preforeclosure claims without question because its automated claim payment system did not have adequate controls in place, such as edit checks, to verify the sales met HUD's minimum requirements for appraisal values and net sale proceeds. Also, HUD does not capture the appraised value in its automated claims processing system, and, therefore, it cannot identify preforeclosure sale claims that do not meet HUD's required minimum appraisal value.

We tested for excessive claims based only upon HUD's effective requirement for a minimum of 52 percent net preforeclosure sales proceeds to the unpaid mortgage balance. Since HUD does not capture the appraised value for preforeclosure sales in its automated systems, we were not able to test for excessive claims that did not meet HUD's required ratio of appraised value to unpaid mortgage balance of 63 percent. Because HUD's controls over claim payments do not include verification of the required appraisal value and data were not available for us to test appraisal values, HUD may have paid additional excessive or ineligible claims we were not able to identify.

## Conclusion

HUD paid at least 52 excessive preforeclosure sale claims totaling approximately \$5.1 million. This occurred because HUD does not have adequate controls within its claim payment system to identify preforeclosure claims that do not meet the program's minimum appraisal value and net sales proceeds requirements. Capturing preforeclosure sale appraisal values and establishing additional edit checks within the claim payment system would help to ensure that preforeclosure sale claims meet HUD's minimum requirements. This information could also be used to identify instances or patterns of potential investor abuse and target preforeclosure claims for review (see finding 1).

## Recommendations

We recommend that the assistant secretary for housing - federal housing commissioner

2A. For the 10 excessive claims identified in finding 2 that did not result in a refund to HUD, require the involved lenders to refund the excessive amounts to HUD as within HUD's authority (see appendix C).

2B. Begin capturing preforeclosure sale property appraisal values within HUD's claims payment system.

2C. Establish controls in HUD's automated claim processing system to prevent payment of obviously excessive claims. This should include checking the ratio of appraisal value to unpaid balance and the ratio of net proceeds to appraisal value.

2D. If HUD is unable to implement recommendations 2B and 2C, 1) require lenders to submit to HUD the final HUD-1 settlement statement and appraisal for preforeclosure claims in which the net sales proceeds are less than a certain amount, such as 60 percent of the unpaid loan balance, and 2) review these documents to determine whether the sales meet HUD's minimum ratios for appraised value and net sales proceeds.

## SCOPE AND METHODOLOGY

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Our audit testing related to preforeclosure sales to investors (finding 1) generally covered the period from October 1, 2002, through January 31, 2005; however, some of the transactions reviewed occurred before these dates. During this period, HUD paid 11,251 preforeclosure sale claims for amounts totaling approximately \$272 million. However, our testing was limited to preforeclosure sales that occurred within the three states with the greatest number of preforeclosure sales during the audit period: Arizona, Utah, and Texas. For the period reviewed, HUD paid 3,113 preforeclosure claims for amounts totaling approximately \$78 million within these three states. Although we did not test to identify preforeclosure sales to investors in Nevada, three Nevada preforeclosure sales were included in our test results. These three cases were identified while reviewing transactions for an investor associated with a number of preforeclosure sales in Arizona.

Testing related to the preforeclosure claims process (finding 2) covered the period October 1, 2001, through January 31, 2005. HUD paid 14,635 preforeclosure sale claims during this period for amounts totaling \$339,227,381. Although we tested for excessive claims based upon HUD's effective requirement for a minimum of 52 percent net preforeclosure sales proceeds to the unpaid mortgage balance, one claim was selected for review solely because the claim amount was greater than the unpaid loan balance, indicating it was likely excessive.

The objectives of the audit were to (1) determine what abuses were occurring within the preforeclosure sale program and how they impacted losses to the Federal Housing Administration insurance fund and (2) evaluate HUD's controls over preforeclosure sales and preforeclosure sale claim processing. To accomplish our objectives, we

- Performed limited reviews at two servicing lenders to evaluate their servicing procedures related to preforeclosure sales.
- Obtained and reviewed claim data from HUD's Single Family Data Warehouse.
- Obtained and reviewed real estate sales data from online public records sources including Lexis Nexis and Realquest services related to preforeclosure sales and resales.
- Reviewed a nonstatistical sample of preforeclosure sales to investors.
- Reviewed data obtained during a recent HUD Office of Inspector General (OIG) investigation related to preforeclosure sales.
- Interviewed program staff from HUD's National Servicing Center, Claims Branch, and Quality Assurance Division.
- Identified preforeclosure sale claims with payoff amounts that were less than 53 percent of the unpaid loan balance and reviewed these cases to determine whether the claims were excessive.

We performed our fieldwork from February through June 2005. We performed our audit in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

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Internal controls are 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.

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## Relevant Internal Controls

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

- HUD's policies and procedures for ensuring Federal Housing Administration preforeclosure sales comply with program requirements.
- HUD's controls to ensure the accuracy of preforeclosure sale claim payments, including automated controls within HUD's claim payment system.

We assessed the relevant controls identified above.

## Significant Weaknesses

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

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

- HUD's controls were not adequate to ensure preforeclosure sales to investors met HUD's requirements (finding 1).
- HUD controls were not adequate to prevent payment of excessive preforeclosure sale claims (finding 2).

## APPENDIXES

### Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A			\$2,421,933
2A	\$156,040	\$588,428	
2C			\$4,386,673

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations. Ineligible costs related to finding 2 represent excessive claim amounts for which HUD has requested (but not yet received) a refund from the lender because of the audit findings.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures. Unsupported costs related to finding 2 represent the total claim amounts of excessive claims not yet refunded to HUD and for which HUD has not yet submitted a refund request to the lender.

3/ “Funds to be put to better use” are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings. Funds put to better use related to finding 1 apply to all of the recommendations but, for recording purposes, we have attached all of the funds to recommendation 1A. Funds to be put to better use related to finding 2 represent the total amount already refunded to HUD for excessive preforeclosure claims identified.

## Appendix B

### EXCESSIVE CLAIM AMOUNTS NOT REFUNDED

FHA case number	Servicer ID number (name)	Unpaid Mortgage Balance	Claim Amount Paid	Questioned amount	Reason claim questioned <sup>a</sup>
052-2453372	3523400009 (RBC Centura Bank)	\$123,669	\$92,239	\$92,239 <sup>b</sup>	Net proceeds less than 52% of unpaid loan balance
052-2693125	6414109996 Countrywide Home Loans	\$230,970	\$158,994	\$158,994	Net proceeds less than 52% of unpaid loan balance
137-0295540	4721900006 (Washington Mutual Bank)	\$76,483	\$92,132	\$63,801 <sup>c</sup>	Claim exceeded unpaid balance
141-0961105	5558209991 (Homestreet Bank)	\$159,670	\$84,191	\$84,191	Equity ratio less than 63%
141-1044128	5558209991 (Homestreet Bank)	\$132,285	\$84,676	\$84,676	Equity ratio less than 63%
141-1045406	5558209991 (Homestreet Bank)	\$112,108	\$85,847	\$85,847	Equity ratio less than 63%
141-1187760	7155500002 (Wells Fargo)	\$159,970	\$80,818	\$80,818	Equity ratio less than 63%
281-2438182	2315509993 (Trustmark National Bank)	\$38,835	\$23,881	\$23,881	Property damage repair cost greater than 10%
321-1994296	1248900007 (Commercial Federal Bank FSB)	\$35,306	\$21,253	\$21,253	Equity ratio less than 63%
521-4844575	1377909991 (Irwin Mortgage Corporation - FNMA)	\$82,303	\$48,768	\$48,768	Equity ratio less than 63%
<b>Total</b>				<b>\$744,468</b>	

<sup>a</sup> Contact HUD OIG Region IX for specific case information regarding noncompliance with preforeclosure sale program requirements.

<sup>b</sup> The lender determined the claim should have been submitted as a conveyance (foreclosure) claim and agreed to refund the \$92,239.

<sup>c</sup> HUD Single Family Claims Branch determined the lender should repay \$63,801 for ineligible claim expenses.