



U.S. Department of Housing and Urban Development
Office of Inspector General for Audit
Great Plains Region, 7AGA
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MEMORANDUM NO: 2003-KC-0802

July 31, 2003

MEMORANDUM FOR: Engram Lloyd, Director, Home Ownership Center, 3AHH

Roger E. Niesen

FROM: Roger E. Niesen, Regional Inspector General for Audit, 7AGA

SUBJECT: Inappropriate Home Ownership Center Instructions.

INTRODUCTION

We have completed an external audit of a Philadelphia Home Ownership Center contractor performing insurance endorsement review procedures. Our objective was to determine if the contractor followed HUD's regulations and their contract terms for reviewing "Late Requests for Endorsement." The audit report on Management Solutions of America (2003-KC-1007) reports the results of the external audit. During that audit, we identified an internal deficiency regarding Home Ownership Center instructions that differed from the HUD Handbook. This memorandum reports the details of this internal deficiency.

METHODOLOGY AND SCOPE

To accomplish our external audit, we tested a representative sample of 155 loan files processed by the endorsement contractor. The loans were processed during the period August 1, 2001 through December 31, 2002. They came from a total universe of 90,364 loans that were endorsed for Federal Housing Administration insurance more than 80 days after closing. We tested the loan files to determine if the contractor followed specific "Late Request for Endorsement" procedures. We interviewed contractor employees to identify the processing procedures that were in place. We also interviewed Home Ownership Center staff, and we reviewed HUD Handbook 4165.1, to identify HUD's requirements for late endorsement procedures. We performed the audit of the contractor in accordance with generally accepted government auditing standards. We provided a draft report to the Home Ownership Center on June 23, 2003. The Center provided their written comments on July 7, 2003. The comments were considered in developing this final report. The complete text of the comments is in Appendix B.

BACKGROUND

The Philadelphia Home Ownership Center awarded a contract to an external contractor to provide endorsement services for the Denver office from July 1, 2001 through June 30, 2002. The scope of the work was to “perform Insurance Endorsement Processing Services on an as needed basis for the U.S Dept. of HUD Philadelphia Home Ownership Center.”

Management Solutions of America was contracted in 2001 for one year at the Philadelphia Home Ownership Center with two available option years. They were contracted to perform a maximum of 676,000 endorsement reviews each year of the contract.

RESULTS OF REVIEW

The Home Ownership Center gave the endorsement contractor guidance that deviated from HUD Handbook 4165.1 for loans submitted for insurance more than 60 days after closing. The Home Ownership Center believed the changes were not significant and allowed necessary flexibility. However, based on this guidance, the contractor approved 46 of the 155 mortgages we tested when those mortgages did not comply with Handbook requirements. The improper endorsement of the 46 mortgages increased the risk to the Federal Housing Administration insurance fund.

According to HUD Handbook 4165.1 Chapter 3, late request for endorsement procedures apply if the mortgage is submitted to HUD more than 60 days after closing. The files for those loans must include specific additional documentation. Late endorsement procedures require the following documentation: an explanation of the delay and actions taken to prevent a recurrence; a certification that escrow accounts are current and intact; a payment ledger reflecting all payments, including payment due in month of submission; and a certification that the lender provided no funds to bring the loan current. Further, no payments can be delinquent. If a delinquent payment exists, the loan cannot be endorsed until the payment ledger reflects six consecutive timely payments.

The Home Ownership Center gave the contractor guidance that was a change from the HUD Handbook 4165.1 Chapter 3. The Home Ownership Center directed the contractor to consider late loan submission letters to be adequate even if they do not contain one of the elements required by the Handbook, specifically the corrective action statement. The Home Ownership Center made this change because they believed the lack of specific verbiage in the late letter was not significant. They agreed with the lenders’ arguments that lenders are trusted to do their own direct underwriting, and therefore should not have files rejected for failure to include a corrective action.

During our review of the contractor, we determined that, out of our sample of 155 loans, 46 loans, valued at \$5,287,484 were inappropriately endorsed because of the instructions provided by the Home Ownership Center. The contractor endorsed the 46 loans according to the Home Ownership Center’s instructions, but the loans should not have been endorsed according to the HUD Handbook.

We believe any reduction or restriction of the controls contained in the Handbook increases the risk to the insurance fund as a whole. For that reason, the Home Ownership Center should require the contractor to follow all requirements of the Handbook.

AUDITEE COMMENTS

The following are excerpts from the Philadelphia Home Ownership Center's comments on our draft report. The complete text of the comments is included in Appendix B.

The Philadelphia Home Ownership Center believes that their endorsement policy is permitted by the Handbook 4165.1. Their comments state: "in paragraph 3-1 of this Handbook, it is stated that 'if the review of the case indicates that the degree of risk to the Department is no greater than existed at the time of closing, the mortgage may be endorsed'. In this regard, it is our position that... the loan can be insured if the lender's explanation for the delay in submitting the loan for endorsement is adequately addressed... By providing such an explanation, one can reasonably infer that the lender is aware of the problem and will take appropriate steps to address this problem in the future."

The auditee further believes that their endorsement policy is consistent with both HUD Headquarters and the other Home Ownership Centers' interpretation of how to implement the Handbook. According to the Philadelphia Home Ownership Center, upon both verbal and written advice received from HUD Headquarters staff, all four Home Ownership Centers agreed that they would not reject an insurance endorsement application if the only item missing was a corrective action statement. They collectively agreed that the degree of risk to the Department on such cases is no greater than existed at the time of closing.

Finally, the Home Ownership Center stated that "with respect to the recommendation to require the contractor to strictly adhere to the requirements set forth in the 4165.1 Handbook, we have been recently advised by Headquarters staff that they intend to issue a Mortgagee Letter in the near future addressing the issue of late endorsement requirements. It is our intent to instruct our contractor to adhere to these instructions when they are issued."

OIG EVALUATION OF AUDITEE COMMENTS

We concur that paragraph 3-1 of Handbook 4165.1 says "if the review of the case indicates that the degree of risk to the Department is no greater than existed at the time of closing, the mortgage may be endorsed." However, we believe this flexibility is intended to be used on a case-by-case basis and not uniformly applied to all late submissions. Our review determined that the Home Ownership Center globally altered the Handbook procedures. Since the Handbook requires Headquarters' approval for changes to Handbook procedures, we concluded the Center's instructions were not appropriate.

Our conclusion that there is an increased risk to HUD is based on the fact that HUD implemented procedures that they developed to reduce risk to the Department on late requests for endorsements. We believe these procedures were carefully thought out and were generally developed to protect the insurance fund from unnecessary losses. Any global restriction of these procedures reduces the overall level of protection to the insurance fund.

HUD is currently in the process of issuing a Mortgagee Letter that will change late endorsement requirements in the Handbook. The Home Ownership Center indicates it intends to require its contractor to comply with the new guidance. These actions, if followed through, should correct the problem outlined in our report. The Home Ownership Center needs to enforce the Handbook procedures or request a formal waiver from Headquarters if they believe a global change to procedures is necessary.

RECOMMENDATIONS

We recommend that the Director, Philadelphia Home Ownership Center:

- 1A. Require the contractor to follow the requirements set forth in HUD Handbook 4165.1, Chapters 2 and 3 when approving late loan submissions for endorsement or request a formal waiver from Headquarters if a global change is considered necessary.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please give us, for each recommendation without a management decision, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Appendix A

FHA CASE FILES FROM RESULTS OF REVIEW

| FHA # | No Indications Action Taken to Prevent Future Late Submissions | Mortgage Amount |
|-------------|--|-----------------|
| 061-2287150 | X | \$132,914.00 |
| 061-2287876 | X | \$87,200.00 |
| 061-2323728 | X | \$138,800.00 |
| 061-2376851 | X | \$117,943.00 |
| 061-2522566 | X | \$125,400.00 |
| 071-0862581 | X | \$110,330.00 |
| 202-0180143 | X | \$113,106.00 |
| 241-6225789 | X | \$94,242.00 |
| 241-6232364 | X | \$109,112.00 |
| 241-6267533 | X | \$131,950.00 |
| 241-6277258 | X | \$89,832.00 |
| 241-6292074 | X | \$94,242.00 |
| 241-6315152 | X | \$93,375.00 |
| 241-6334927 | X | \$52,500.00 |
| 241-6362391 | X | \$121,000.00 |
| 241-6609796 | X | \$119,059.00 |
| 249-3907220 | X | \$96,662.00 |
| 249-4248219 | X | \$133,895.00 |
| 249-4294018 | X | \$183,549.00 |
| 249-4321109 | X | \$98,856.00 |
| 249-4325668 | X | \$188,411.00 |
| 251-2729891 | X | \$136,521.00 |
| 261-7658204 | X | \$144,596.00 |
| 261-7714749 | X | \$148,187.00 |
| 263-3272442 | X | \$101,801.00 |
| 263-3307167 | X | \$87,238.00 |
| 351-3985853 | X | \$67,903.00 |
| 351-3986678 | X | \$104,100.00 |
| 351-4015316 | X | \$134,150.00 |
| 352-4107138 | X | \$134,750.00 |
| 352-4319200 | X | \$158,729.00 |
| 352-4407912 | X | \$153,721.00 |
| 371-2853295 | X | \$55,200.00 |
| 371-3028015 | X | \$41,292.00 |
| 411-3352399 | X | \$48,515.00 |
| 412-4649430 | X | \$78,665.00 |
| 413-3699077 | X | \$65,864.00 |
| 413-3766845 | X | \$211,933.00 |
| 441-6540856 | X | \$80,844.00 |
| 541-5905626 | X | \$124,950.00 |

| FHA # | No Indications Action Taken to Prevent Future Late Submissions | Mortgage Amount |
|---------------|--|-----------------------|
| 541-6089081 | X | \$122,950.00 |
| 541-6190731 | X | \$97,182.00 |
| 541-6200483 | X | \$58,763.00 |
| 543-0131617 | X | \$251,100.00 |
| 548-3796796 | X | \$198,752.00 |
| 571-0639366 | X | \$47,400.00 |
| TOTALS | 46 | \$5,287,484.00 |

Appendix B

Auditee Comments

June 25, 2003

MEMORANDUM FOR: Roger Niesen, Regional Inspector General for Audit, 7AGA

FROM: Engram Lloyd, Director, Homeownership Center, 3AHH

SUBJECT: Comments on Draft Audit Report

Per your request, we have completed our review of the draft audit report relative to the processing of late requests for endorsement by our Homeownership Center. Our detailed comments relative to this draft report are discussed below. However, it is our belief that 1) our endorsement policy is permitted by the 4165.1 Handbook 2) our endorsement policy is consistent with both HUD Headquarters and the other Homeownership Centers' interpretation of how to implement the Handbook and 3) our endorsement policy does not increase the risk to the Department.

The draft audit report states that the Homeownership Center gave the contractor guidance that deviated from HUD Handbook 4165.1 for loans submitted for insurance more than 60 days after closing. It further states that the Homeownership Center directed the contractor to consider late loan submission letters to be adequate even if they do not contain one of the elements required by the Handbook, specifically the corrective action statement. A conclusion is then made that the improper endorsement of the 46 mortgages that were identified as having this deficiency increased the risk to the Federal Housing Administration insurance fund.

We disagree with this conclusion. The requirements for the processing of late requests for endorsement are contained in Chapter 3 of the 4165.1 Handbook. In paragraph 3-1 of this Handbook, it is stated that "if the review of the case indicates that the degree of risk to the Department is no greater than existed at the time of closing, the mortgage may be endorsed". In this regard, it is our position that, if a lender submits a payment ledger indicating that the loan is current as well as certifications that the escrow accounts are current and intact and that they did not provide funds to bring the loan current, the loan can be insured if the lender's explanation for the delay in submitting the loan for endorsement is adequately addressed – although they do not specifically reference what steps that they are going to take to prevent future delayed submissions. By providing such an explanation, one can reasonably infer that the lender is aware of the problem and will take appropriate steps to address this problem in the future. It certainly does not make good business sense to incur the expense of mailing back insurance endorsement files to a mortgage lender asking them to provide us a statement as to what they will do in the future to correct late submissions when all other required documentation is contained in the file. Our Notice of Return (NOR) rates would greatly

increase if we followed this practice and we would no doubt lose customers and our loan volume would decline.

The policy of insuring such submissions was not implemented unilaterally by our Homeownership Center. Instead, upon both verbal and written advice received from HUD Headquarters staff, all four Homeownership Centers agreed that we would not reject an insurance endorsement application if the only item missing was a corrective action statement. It was collectively agreed to that the degree of risk to the Department on such cases is no greater than existed at the time of closing. This assumption has been validated by the cases referenced in your draft audit report. For example, as of June 24, 2003, on the 46 cases referenced – a total of 25 of these loans have already been paid off and the remaining 21 loans are reflected as being current. Not one of these loans has been reported as being delinquent and no claims have been paid by the Department on any of these loans. Copies of E:Mail messages from Headquarters staff and the other three Processing & Underwriting Division Directors regarding this policy were provided to the OIG Auditor. We can again supply you with these documents if you so desire.

With respect to the recommendation to require the contractor to strictly adhere to the requirements set forth in the 4165.1 Handbook, we have been recently advised by Headquarters staff that they intend to issue a Mortgagee Letter in the near future addressing the issue of late endorsement requirements. It is our intent to instruct our contractor to adhere to these instructions when they are issued.

Please contact Gerry Glavey, Director of the Processing & Underwriting Division, at (215) 656-0578, ext. 3034 if you have any questions relative to the issues discussed in this memorandum.