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TO: Engram Lloyd, Director, Philadelphia Homeownership Center, Pennsylvania  
State Office, 3AHH

*Daniel G. Temme*

FROM: Daniel G. Temme, Regional Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: Philadelphia Homeownership Center  
Quality Controls Over Single Family Loan Insurance Process  
Philadelphia, Pennsylvania

### INTRODUCTION

We audited the Philadelphia Homeownership Center's (HOC's) Quality Controls over its Single Family Loan Insurance Process. The objective of the audit was to examine the integrity of the HOC's and its contractors' system of quality controls over mortgage loans submitted for Federal Housing Administration (FHA) insurance endorsement.

To accomplish our objective, we: reviewed applicable Federal and HUD regulations and other applicable materials to gain an understanding of requirements related to Single Family loan insurance endorsements; interviewed responsible staff from the Office of Single Family Housing, the HOC, and the endorsement and post-endorsement contractors; reviewed current and prior audits of the Single Family Program performed by GAO, HUD, and an Independent Public Accountant; examined the HOC's policies, procedures, files, records, plans, contracts, and reports; and reviewed 20 endorsement and 20 post-endorsement reviews performed by the applicable contractors.

We performed our work at the Office of Single Family Housing, the HOC, and the contractors' offices between May 2003 and November 2003. The review covered the HOC's insurance endorsement operations from October 2000 through September 2003. However, certain tests we performed pertained to transactions outside that timeframe. We used Computer Assisted Audit Techniques to perform various analyses during the review. We performed the audit in accordance with generally accepted government auditing standards.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide 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.

Should you or your staff have any questions, please contact J. Phillip Griffin, Assistant Regional Inspector General for Audit, at (215) 656-3401, extension 3490.

### **SUMMARY**

As part of our national review of the HOCs, we reviewed the Philadelphia HOC's system of quality controls over its FHA Single Family Loan Insurance Process. The scope of the review examined the services of the HOC's endorsement and post-endorsement contracts as well as the HOC's monitoring of those services. We identified two significant weaknesses in the HOC's monitoring of the endorsement and post-endorsement processes. Specifically, we found the HOC was not aware its contractors were not performing the required number of quality control reviews specified in their contracts. Further, the HOC staff did not accurately measure the post-endorsement contractor's performance level in determining what payments the contractor was entitled to receive. As a result of inadequate monitoring, the HOC: overpaid the endorsement contractor \$75,387; overpaid the post-endorsement contractor \$326,572; and increased the risk that HUD will insure unacceptable loans. Management action to correct these deficiencies will put \$144,944 to better use over a 12-month period.

The HOC was not aware the contractors did not perform the reviews because its monitoring reviews were not sufficiently detailed. Also, staff incorrectly calculated performance levels for its contractors because they: did not fully understand what data elements they should use in the calculation under the terms of the contract; ran the automated program to calculate performance before they entered key information into the system; and did not routinely update all necessary data elements in the database.

The HOC generally agreed with the recommendations to improve the controls related to quality control reviews as they pertain to the endorsement and post-endorsement contractors. The HOC discussed noted issues with the endorsement and post-endorsement contractors and the contractors took action to correct some weaknesses identified. However the HOC needs to take further action to correct other noted weaknesses.

### **BACKGROUND**

HUD's Strategic Plan states that part of its mission is to increase homeownership, support community development, and increase access to affordable housing free from discrimination. HUD provides a wide variety of tools to foster this goal of increasing homeownership opportunities. The overall strategy is to carefully apply public sector dollars, whether through mortgage insurance, grants, loans, or direct subsidies, to

leverage the private market and make it easier for low- and moderate-income Americans to buy and keep their own homes.

The National Housing Act, as amended, established the FHA, an organizational unit within the Department of HUD. The FHA provides insurance for mortgagees against loss on single-family home mortgages.

Since 1993, and with many matters recently, the Office of Single Family (which includes its four HOCs) has implemented or is in the process of implementing several initiatives to improve the single-family insurance program. These include:

- Implementing a five-year Business Process Reengineering Plan which addresses increased use of automated underwriting and electronic endorsements;
- Performing a pilot program of contracting out on-site lender reviews and then canceling the unsuccessful contracts;
- Staffing the Quality Assurance Division to enable it to perform more than 900 on-site lender reviews per year;
- Developing methods or implementing systems for targeting high risk lenders and appraisers for review, which includes:
  - Testing and implementation of the Neighborhood Watch Appraiser Targeting System at the Philadelphia Homeownership Center;
  - Implementing and using Credit Watch Terminations;
  - Using a more precise algorithm to identify high risk lenders and appraisers;
  - Increasing use of fraud checks; and
  - Using data to identify trends;
- Emphasizing to approved mortgagees that they should perform due diligence reviews when purchasing loans;
- Initiating changes designed to strengthen the licensing and certification requirements for placement on the FHA appraiser roster;
- Developing and testing the FHA Technology Open To All Lenders (TOTAL) Scorecard<sup>1</sup> as a way to assess the credit worthiness of FHA borrowers in an objective and consistent manner; and
- Publishing mortgage insurance regulations to prevent the practice of flipping<sup>2</sup> on properties that will be financed with FHA-insured mortgages.

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<sup>1</sup> According to HUD managers, TOTAL scorecard has been statistically proven to accurately predict the likelihood of borrower default by evaluating certain mortgage application and borrower credit information.

The Philadelphia HOC employs 218 staff, 62 of which are located in the Processing and Underwriting Division. This Division is responsible for overseeing the endorsement contractor who is responsible for reviewing loan files for completeness and performing other tasks related to endorsing loans. The Division is also responsible for overseeing the post-endorsement contractor that reviews loan files after they were endorsed, primarily to evaluate the quality of the underwriter's efforts and to identify the degree of risk in each case file insured. From FY 2001 through FY 2003, the Division endorsed more than one million loans valued in excess of \$123 billion.

## **FINDING 1**

### **THE HOC'S MONITORING OF ENDORSEMENT AND POST-ENDORSEMENT PROCESSES NEEDS IMPROVEMENT**

The Philadelphia HOC's oversight of its endorsement and post-endorsement contractors needs improvement in two areas. Specifically, the HOC was unaware the contractors did not perform required quality control reviews because its monitoring reviews were not detailed. Further, HOC staff did not accurately measure the post-endorsement contractor's performance level in determining what payments the contractor was entitled to receive. In monitoring the contractor's performance level, used to compute contractor payments, the staff: did not fully understand what data elements they should use in the calculation under the terms of the contract; ran the automated program to calculate performance before they entered key information into the system; and did not routinely update all necessary data elements in the database. As a result of inadequate monitoring, the staff: overpaid the endorsement contractor \$75,387; overpaid the post-endorsement contractor \$326,572; and increased the risk that HUD will insure unacceptable loans. Management action to correct these deficiencies will put \$144,944 to better use over a 12-month period.

HUD Handbook 2210.3 REV-9, Procurement Policies and Procedures, emphasizes the importance of contractor monitoring. Paragraph 12-15 states the evaluation and reporting of a contractor's performance constitutes one of the most critical tasks that the Government Technical Representative performs. Performance is measured against the specific requirements of each contract. It is measured in both qualitative (i.e., how well work was performed) and quantitative (e.g., timeliness) terms. Contractor performance reports enable the Contracting Officer to determine if the contractor is meeting the contractual terms and, if not, what action is required on his/her part. They provide program office management the information needed to determine if a contract is yielding what was required (and in some cases anticipated) and, if not, what effect it will have on program mission. Last, performance reports provide a record of the contractor's performance, which can be used in evaluations of the contractor for future contract awards.

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<sup>2</sup> Property flipping is a practice whereby a recently acquired property is resold for a considerable profit with an artificially inflated value, often abetted by a lender's collusion with the appraiser.

The endorsement and post-endorsement contracts require compliance with Federal Acquisition Regulation 52.246-04. That Regulation permits the government to inspect and test all services called for by the contract. Complete records of all inspection work performed by the contractor shall be maintained and made available to the government during contract performance and for as long afterwards as the contract requires. If any of the services do not conform with contract requirements, the government may require the contractor to perform the services again in conformity with contract requirements, at no increase in contract amount. When the defects in services cannot be corrected by re-performance, the government may:

- Require the contractor to take necessary action to ensure that future performance conforms to contract requirements, and
- Reduce the contract price to reflect the reduced value of services performed.

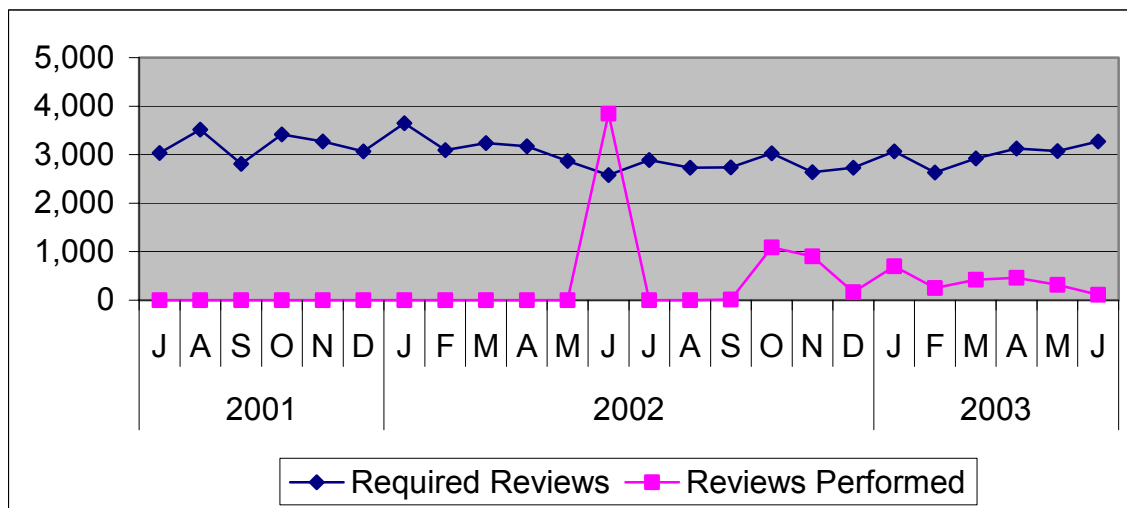
#### **A. Required Quality Control Reviews Were Not Completed**

The HOC's monitoring reviews were not adequate to detect that the endorsement and post-endorsement contractors did not perform the required number of quality control reviews. HUD's Procurement Policies and Procedures Handbook requires the HOC to perform adequate contract monitoring reviews. Because the reviews were not adequate, the HOC overpaid the endorsement contractor \$75,387 and overpaid the post-endorsement contractor \$141,202. Furthermore, the contractors may not have performed at their optimum level since they did not analyze the results of the undocumented reviews and take corrective action to address causes of noted repetitive deficiencies they would have identified if they performed and documented the reviews as required. As a result, the contractors increased the risk that HUD insured unacceptable loans.

#### **Endorsement Quality Control Reviews**

For reviews from July 2001 through June 2003, the contractor could only provide documentation to support 8,461 quality control reviews, or 1.17 percent of the 725,658 endorsements. The contract required the contractor to perform quality control reviews of 10 percent of the endorsements, or 72,566 quality control reviews for this two-year timeframe. The endorsement contractor could not provide any documentation to support the contractually required 35,134 quality control reviews the contractor was to perform prior to June 2002. After that timeframe, the contractor performed the reviews sporadically throughout the month and not every day as required.

### Endorsement Reviews Performed vs. Required



The Contract Manager said his staff performed other kinds of quality control reviews throughout the endorsement process, not just at the end as required by the contract. However, the contract or the Quality Control Plan also required performance of these reviews and they were intended to be performed in addition to the 10 percent quality control review.

The HOC’s staff did not have a copy of the endorsement contractor’s quality control plan and expressed unfamiliarity with the forms the contractor used to perform the reviews. Further, one of the two representatives claimed to have reviewed the contractor’s quality control records once or twice a week, while the other representative (who is no longer in the Processing and Underwriting Division) said they (the two representatives together) reviewed the contractor’s quality control records about once every six months. Both representatives said the contractor performed the required reviews, but they did not document their oversight of the reviews. Based on the records provided by the contractor and the lack of oversight documentation, we could not reach the same conclusions the representatives did as to the number of reviews actually performed.

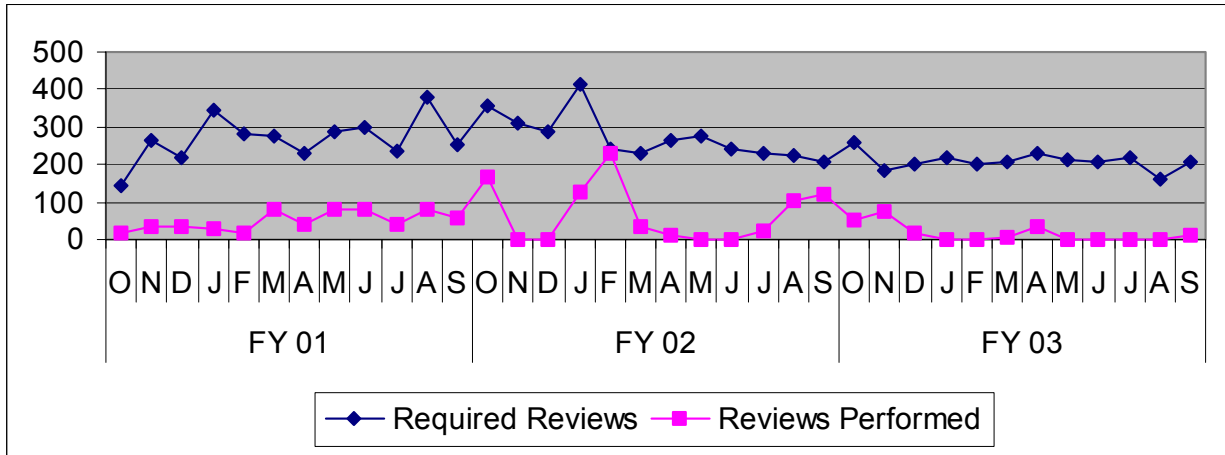
The contractor was not able to document compliance with the terms of the contract regarding the required number of quality control reviews. Therefore, we concluded the contractor did not perform the reviews. Using available information, we determined that HUD’s cost incurred for reviews not performed was \$75,387. Management action to correct this deficiency will put \$35,005 to better use over a 12-month period.

**Post-Endorsement Quality Control Reviews**

For reviews from October 2000 through September 2003, the contractor only provided documentation to HUD to support 1,676 quality control reviews, or 1.86 percent of the 89,890 loans forwarded for review. The contract required the contractor to perform

quality control reviews of 10 percent of the endorsements, or 8,989 quality control reviews.

**Post-endorsement Reviews  
Performed vs. Required**



The contractor did not comply with the terms of the contract because the contractor did not provide Quality Control Review Sheets, used to document quality control reviews, to HUD along with the invoices. Therefore, we concluded the contractor did not perform the reviews. Using available information, we determined that HUD’s cost incurred for reviews not performed for Fiscal Years 2001 through 2003 was \$141,202. Management action to correct this deficiency will result in the contractors being paid correctly and will put \$55,152 to better use over a 12-month period.

**B. Post-endorsement Contractor’s Performance Not Accurately Measured**

The HOC did not accurately measure the post-endorsement contractor’s performance level in determining what payments the contractor was entitled to receive. HOC staff incorrectly calculated the contractor’s performance level because they: did not fully understand what data elements were to be used in the calculation under the terms of the contract; ran the automated program to calculate performance before they entered key information into the system; and did not routinely update all necessary data elements in the database. As a result, the HOC overpaid the post-endorsement contractor \$185,370. Furthermore, the HOC did not have an automated test for integrity of a specific rating category and as a result, the HOC missed an opportunity to improve the processes of another contractor. The HOC staff was not aware it should have been reviewing this rating category assigned by the post-endorsement contractor.

The types of performance level miscalculation errors follow:

- HOC underwriters did not always update the “QC Adjustment” field in the Underwriting Reporting System due to either oversight or a misunderstanding of when to update the field. The System uses this field to identify a loan file that

HOC staff selected for review to determine the contractor's performance level. During FY 2003, the HOC's underwriters did not identify 29 loans they should have included in determining the contractor's performance level.

- The HOC excluded contractor's mistakes or omissions not associated with rating changes when calculating the contractor's performance level. The HOC's staff was not aware the contract required inclusion of these mistakes or omissions when determining the contractor's performance level. Hence, they did not include the necessary steps in the automated programming logic to include review of the field that underwriters were supposed to update when they identified these types of errors or omissions. During FY 2003, the staff excluded 269 errors or omissions when determining the contractor's performance level because they were not aware of the requirement to include these types of errors in calculations.
- HOC staff prematurely determined the contractor's performance level. Generally, the staff ran the automated program, which calculated the contractor's performance level, about 15 days after the end of the month invoiced. This did not allow underwriters sufficient time to complete and record their reviews in the Underwriter Reporting System. The contract allowed for the application of adjustments to the following month's invoice but the staff was unaware of this contract provision allowing for additional time. During FY 2003, the automated program did not include 325 loans in determining the contractor's performance level because the staff ran the automated program prematurely. Although the staff did not record these reviews in time to be included in the calculations, the staff did include more than the contractually required number of reviews in the calculations.
- HOC underwriters, when they disagreed with the quality of the contractor's technical reviews, did not always identify their reason for disagreement by updating one of two fields. When disagreeing, the underwriters record their identification of an error or omission in a "Comment" field. Then the underwriters are supposed to classify their reason for disagreement as either: resulting in a rating change, or not resulting in a rating change. This allows the automated program to include the records in the computation of the contractor's performance level. During FY 2003, HOC staff did not update one of the two fields for 61 records in the Underwriting Reporting System when the "Comments" field contained statements identifying errors or omissions. Had the HOC performed data integrity reviews, it would have identified these incomplete records.

These combined errors caused the HOC to miscalculate the contractor's performance level. For FY 2003, the HOC determined average performance level was 92.7 percent while the actual performance level was 82.1 percent. Analysis of the performance level on a monthly basis disclosed that for FYs 2001 through 2003, the contractor was overpaid \$185,370. Management action to correct these deficiencies will result in the contractor being paid correctly and put \$54,787 to better use over a 12-month period.



The HOC did not have an automated test for integrity. During a review of 20 loan files we identified 4 loan files where the “Closing” technical ratings assigned by the post-endorsement contractor were inaccurate. HOC staff incorrectly believed the endorsement contractor assigned the “Closing” technical rating. Hence, they did not review this technical rating and did not identify these incorrect ratings. We performed an automated test for this specific error. During FY 2003, the post-endorsement contractor assigned 519 incorrect “Closing” ratings. Had staff been aware of the contractual requirement for the post-endorsement contractor to assign the rating they could have reviewed the “Closing” ratings. The HOC could have designed and implemented a data integrity test to detect this condition. Also, because the HOC did not review this rating classification, they missed the opportunity to inform the endorsement contractor of the errors so that contractor could improve its processes.

Of even greater concern is the fact that since the calculations were incorrect, HOC managers were unaware of the contractor’s true performance and therefore were unable to address the causes of the deficient performance. The technical review of the mortgagee underwriting is critical to the success of the Office of Single Family Loan Program. Since underwriting decisions rely heavily on the subjective interpretation of the mortgagee, it is imperative that the HOC responds to underwriting problems. Since HUD’s underwriters were identifying deficient contractor technical reviews, it was possible that not all loans warranting HUD attention were identified.

#### **Corrective Action Taken by Auditee**

We informed the Philadelphia HOC’s management that the endorsement contractor did not perform the required 10 percent reviews and management informed us they directed the contractor to comply with the terms of the contract. The HOC provided us logs of the contractor’s reviews completed after the period of the audit. The contractor was performing the required number of reviews. However, we were unable to determine if the reviews complied with the contractor’s Quality Assurance Plan because the HOC did not provide us a copy of the Plan.

We discussed the performance of the post-endorsement contractor with HOC staff. They discussed the issues with the contractor and the contractor revised its Quality Assurance Plan. The HOC provided us a copy of the Plan that addressed one issue that pertained to the “Closing” technical rating. Managers said that they reviewed and approved the Plan. However, we were unable to determine if the contractor implemented the revised portion of the Plan. Further, although HOC staff said the contractor was performing the required number of quality control reviews, the HOC was not able to substantiate its claim.

## AUDITEE COMMENTS

The HOC provided us its written comments to the report via an email on February 9, 2004. Although the HOC generally agreed with most of the issues and recommendations presented in the report, they did disagree with two issues.

First, the HOC said it is not appropriate to seek reimbursement from its contractors for their failure to properly document that they completed the required number of quality control reviews. Regarding the endorsement contractor, they expressed confidence that the contractor performed the required 10 percent quality control reviews but simply did not properly document them. As for the post-endorsement technical review contractor, they stated the contractor also performed adequate numbers of quality control reviews under their past contract which has now expired. Secondly, the HOC said the error rate, as established by terms of the contract for their post-endorsement technical review contractor, was consistently below 10 percent. The HOC said the OIG Auditors mistakenly calculated the error rate by including all cases that contained minor errors/omissions as opposed to only those cases that contained significant errors/omissions.

However, the HOC agreed it needed to enhance its monitoring of the endorsement and post-endorsement contractors. In response to the audit, the HOC obtained and reviewed the endorsement contractor's Quality Control Plan. The HOC also contacted the endorsement and post-endorsement contractors and reminded them of the requirement to perform and document their quality control reviews. The HOC verified the endorsement contractor is now performing and documenting its quality control reviews. Further, the HOC reminded the post-endorsement contractor to submit evidence of its quality control reviews with its invoices as required by the contract. The post-endorsement contractor informed the HOC that it is performing and documenting its quality control reviews and HOC staff is planning to visit the contractor to ensure that the reviews are being performed and documented.

The HOC said it would continue to require evidence of each contractor's Quality Control reviews each month before authorizing their monthly payment vouchers. If the contractor cannot provide evidence of the reviews, the HOC will refuse to authorize payment of their voucher. Also, the HOC will work with the Regional Contracting Division to initiate proper actions if the contractor continually fails to provide such documentation.

The HOC also agreed that improvements are needed to properly calculate the post-endorsement contractor's acceptable performance level. The HOC agreed to review and revise its procedures for calculating the contractor's performance. However, the HOC disagrees that the post-endorsement contractor should be required to repay \$185,370 for not performing at an acceptable level in the past since the error rate, calculated manually by the Government Technical Representative, was consistently below the 10 percent Acceptable Performance Level. The HOC said the auditors mistakenly calculated the

error rate by including all cases that contained minor errors or omissions as opposed to only those cases that contained significant errors or omissions.

### **OIG EVALUATION OF AUDITEE COMMENTS**

The HOC's planned actions to ensure that the endorsement and post-endorsement contractors document their quality control reviews is commendable. However, the contractors and the HOC could not provide adequate evidence to demonstrate the contractors actually performed the required number of reviews for the period addressed by the audit. Hence, the HOC still needs to require the contractors to pay for the reviews not performed. Regarding the error rate calculations, the auditors used the criteria specified by the contract, which did not specify that only significant errors or omissions should be counted as errors.

### **RECOMMENDATIONS**

We recommend the Philadelphia Homeownership Center:

1A. Perform adequate monitoring reviews of the endorsement and post-endorsement contractors to ensure they perform according to the terms of their respective contracts. As part of this monitoring, the HOC should:

- Obtain and review a copy of the endorsement contractor's Quality Control Plan for adequacy;
- Ensure the endorsement and post-endorsement contractors perform quality control reviews of the specified number of loan files; and
- Accurately compute the performance level for the post-endorsement contractor. These computations should include: consistently updating automated records; performing timely calculations; including appropriate types of errors; and performing data integrity reviews.

Correction of these deficiencies will result in the contractors being paid correctly and will put \$144,944 (\$35,005 for endorsement quality control reviews not performed, \$55,152 for post-endorsement quality control reviews not performed, and \$54,787 for incorrect post-endorsement contractor performance level calculations) to better use over a 12-month period.

1B. Require the endorsement contractor to pay \$75,387 for the reviews not performed.

1C. Require the post-endorsement contractor to pay \$141,202 for the reviews not performed. Also, require the contractor to pay \$185,370 for the value of the quality control reviews that it did not perform at the acceptable performance level.

## MANAGEMENT CONTROLS

Management controls include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

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

- Endorsement processing
  - Quality control reviews of the contractor's reviews
  - Monitoring controls including:
    - Calculations of contractor performance levels
    - Accuracy of contractor payments
  
- Post-endorsement technical review processing including:
  - Quality control reviews of the contractor's reviews
  - Accuracy and completeness of the Underwriting Reporting System
  - Monitoring controls including:
    - Calculations of contractor performance levels
    - Accuracy of contractor payments

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

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

- Endorsement processing including:
  - Quality control reviews of the contractor's reviews
  - Monitoring controls including:
    - Calculations of contractor performance levels
    - Accuracy of contractor payments
  
- Post-endorsement technical review processing including:
  - Quality control reviews of the contractor's reviews
  - Accuracy and completeness of the Underwriting Reporting System
  - Monitoring controls including:
    - Calculations of contractor performance levels
    - Accuracy of contractor payments

## **FOLLOW-UP ON PRIOR AUDITS**

This is the first audit of the Philadelphia HOC's Quality Controls Over its Single Family Loan Origination Process by HUD's Office of Inspector General.

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

<u>Recommendation Number</u>	<u>Type of Questioned Cost</u>	
	<u>Ineligible 1/</u>	<u>Funds Put to Better Use 2/</u>
1A		\$144,944
1B	\$ 75,387	
1C	\$326,572	

1/ Ineligible costs are those that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.

2/ Funds put to better use are monetary savings resulting from management actions, in response to OIG recommendations, that prevent improper obligations or expenditures of agency funds or avoid unnecessary expenditures. The following categories of future monetary savings are funds put to better use: reductions in outlays; de-obligation of funds from programs or operations; withdrawal of interest; loans and guarantees not made; costs not incurred; avoidance of unnecessary expenditures; and other savings.