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# AUDIT REPORT



## Nationwide Review of Indemnification for Claims on Single Family Insured Loans

Department of Housing and Urban Development's Single Family Insurance Program

2004-DE-0001

December 15, 2003

Office of Audit, Region 8  
1670 Broadway, 24<sup>th</sup> Floor  
Denver, Colorado 80202

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Issue Date
December 15, 2003
Audit Report Number
2004-DE-0001

**TO: John C. Weicher, Assistant Secretary for Housing – Federal Housing  
Commissioner, H**

**FROM: Robert C. Gwin, Regional Inspector General for Audit, 8AGA**

**SUBJECT: Indemnification for Claims on Single Family Insured Loans  
Department of Housing and Urban Development's Single Family Insurance  
Program**

We have completed an audit of the indemnification for claims on Single Family insured loans. We selected the audit because of concerns we had with the collection of losses from claims where indemnification agreements are in place. The assignment was on our annual audit plan. Our overall audit objective was to evaluate the controls in place to ensure indemnification agreements are adhered to, and the lender reimburses HUD for losses incurred by HUD when a claim is paid.

Our report contains three findings with recommendations requiring action by your office. The three findings address the billing and collection process, and the data entry of indemnification information into HUD systems.

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 me at (303) 672-5452.

Management Memorandum

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# Executive Summary

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We performed a nationwide audit of the indemnification for claims on Single Family insured loans at the Office of Housing, which is part of the Federal Housing Administration (FHA). FHA is a government-owned mortgage insurer that is part of the U.S. Department of Housing and Urban Development. Our audit work at the Office of Housing included reviews at three Homeownership Centers, the Enforcement Center, the Single Family Claims Branch and the outside contractor who is the custodian of the indemnification agreements and prepares the billing letters. We performed the audit to evaluate the controls in place to ensure indemnification agreements are adhered to, and the lender reimburses HUD for losses incurred by HUD when a claim is paid.

Last year, the Department took steps to improve the tracking of indemnified loans, updated the language of the indemnification agreements and disclosed indemnification information to the single family housing industry. We found that the loan indemnification information entered into HUD's automated systems is generally complete and reliable. However, additional work is needed to improve the processes for billing and debt collection. We found that HUD has not consistently billed lenders in a timely manner for monetary sanctions, imposed by the Department, through FHA loan indemnification agreements. HUD needs to bill lenders for losses of \$44.4 million resulting from 1,231 property disposition claims. Contrary to Treasury's debt collection requirements, HUD's debt collection process did not support active collection of FHA indemnified loan debt. Debts totaling \$15.8 million that had been delinquent 180 days or more were not transferred to Treasury for collection; accrual of interest and penalties on delinquent debt was improperly suspended; and debts delinquent more than 90 days were not properly reported to Treasury. Furthermore, additional controls over the data entry of indemnification information into HUD systems may further improve the accuracy of indemnification agreement information.

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## HUD Has Taken Steps to Improve the Loan Indemnification Process

The Department recently enhanced its automated systems to improve the loan indemnification process by: tracking additional information; establishing an interface between two HUD systems to automatically flag indemnified loans in the claims payment system; and if the original indemnified loan is streamline refinanced, automatically transferring the loan indemnification to the new case. HUD also updated the standard indemnification agreement language and began disclosing pertinent loan indemnification information to the industry, on a case-by-case basis, in the *Neighborhood Watch System*.

We found that the loan indemnification information entered into HUD's automated systems is generally complete and reliable. However, additional work is needed to improve the processes for billing and debt collection.

### HUD Needs to Bill Lenders In a Timely Manner

Federal agencies are required to service and collect debts in a manner that best protects the value of the Government's assets. HUD has not consistently billed lenders in a timely manner for monetary sanctions, imposed by the Department, through FHA loan indemnification agreements. HUD needs to bill lenders for losses of \$44.4 million resulting from 1,231 property disposition claims.

The Office of Housing's Claims Branch is responsible for tracking properties covered by indemnification agreements and initiating the billing process when property disposition losses occur. The process to identify indemnified property disposition and associated losses is not automated and requires extensive manual research. Additionally, the following circumstances impacted the billing process: additional research was necessary to determine the actual sales discount, missing copies of the indemnification agreements needed to be located, claims application part B needed to be closed, and a system conversion caused a backlog of agreements.

### Debt Collection Activities Needs Improvement

HUD needs to formulate and implement debt collection policies regarding FHA indemnified loan debt to ensure that the Department is in compliance with the Department of the Treasury's debt collection requirements. Federal agencies are required to promptly act on the collection of delinquent debts, using all available collection tools to maximize collections. Contrary to Treasury's debt collection requirements, HUD's debt collection process did not support active collection of FHA indemnified loan debt. Debts totaling \$15.8 million that had been delinquent 180 days or more were not transferred to Treasury for collection; accrual of interest and penalties on delinquent debt was improperly suspended; and debts delinquent more than 90 days were not properly reported to Treasury. HUD also needs to ensure that all recorded debts are still valid and collectable.

The Office of Housing's Claims Branch that oversees the collection process is primarily responsible for managing all Single Family claim payments, only a small percentage of which are indemnified and require the collection of losses. Housing officials advised that due to workload constraints and the lack of debt collection expertise, the Claims Branch lacked the resources to effectively manage the debt collection process. HUD's debt collection process did not

comply with Treasury's intent concerning the administrative offset provision of the Debt Collection Improvement Act. Additionally, HUD's collection process stopped accruing interest on outstanding debt when this debt was placed in a delayed status in the system.

### Internal Controls for Processing Indemnification Agreements Can Be Improved

Furthermore, HUD is committed to ensuring and maximizing the quality, utility, objectivity and integrity of information it disseminates to the public. We found that data in the HUD systems for the indemnification agreements in our sample was generally complete and reliable. However, we did identify control weaknesses that allowed data errors to get into the systems.

The HUD Quality Assurance Division has not formulated policies or procedures related to the internal indemnification processing outside of the data entry into the *Computerized Home Underwriting Management System*. The lack of current policies and procedures contributed to processing inconsistencies or misunderstandings resulting in errors. Consequently, inaccurate indemnification agreement information may get into HUD systems that can delay the billing process or lapse the indemnification period earlier than intended.

### Recommendations

We believe that enhancing processes for billing and collecting losses resulting from indemnified loans can improve the effectiveness of sanctions imposed by the Department against participants of the Single Family Insurance program.

Timely billing increases the likelihood that HUD will recover its losses from indemnified loans and increases the effectiveness of sanctions used by the Department. HUD needs to initiate the billing process for 1,231 cases and enhance systems to automate the billing process and accurately calculate the current profit and loss on sale amount.

HUD needs to follow the debt collection requirements by actively pursuing collection of delinquent debts; transferring debt delinquent 180 days or more to Treasury; ensuring that interest and penalties are accrued on all eligible debt; and properly disclosing delinquent debts on the quarterly report to Treasury.

Furthermore, HUD can improve controls over data in its automated systems by formulating and implementing policies and procedures, that include independent verification of the data entry to ensure that the information is valid; and address inconsistencies or misunderstandings described in the report concerning agreement dates and the refinance indicator.

### Auditee Comments

We submitted a preliminary draft report to HUD on September 24, 2003. We received verbal comments on the draft report from HUD on October 1, 2003 and written comments from the Claims Branch on October 3, 2003. We considered HUD's written and verbal comments to the preliminary draft report, and made the appropriate changes to the final draft report. We submitted the final draft to HUD on October 28, 2003. The Assistant Secretary for Housing - Federal Housing Commissioner provided written comments to our final draft report on November 26, 2003. The Assistant Secretary concurred with our audit results and agreed to implement a number of actions to respond to the issues identified in our report. The Assistant Secretary's comments are included in its entirety in Appendix E.

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### Abbreviations:

HUD	U.S. Department of Housing and Urban Development
OIG	Office of Inspector General
FHA	Federal Housing Administration
Treasury	U.S. Department of the Treasury
OMB	Office of Management and Budget
M&M	Management and Marketing
HUD-1	Real Estate Settlement Procedures Act (RESPA) Uniform Settlement Statement

# Introduction

An indemnification agreement is a tool used by HUD to sanction lenders who commit some kind of irregularity, either through fraud or a violation of HUD policies and procedures in originating or servicing a mortgage that has been insured by HUD. If the error is detected prior to insurance, endorsement is denied until the problem is resolved; if the loan is already insured, HUD will initiate the indemnification process.

In the terms of the indemnification agreement the lender may agree that if a claim is filed, the claim will be reduced by a specific dollar amount, or the lender may agree to forego filing an insurance claim for a specific period of time or for the life of the loan. Typically the period of time used by HUD in the indemnification agreements is five years. However, under certain conditions, such as property defects or delinquent payments prior to endorsement, the lender may be required to indemnify HUD throughout the life of the loan. If there is a streamline refinance of the loan during the indemnification period, the indemnification agreement will follow the new loan if the agreement was a result of origination deficiencies. The indemnification agreement will not follow a streamline refinance if the agreement was the result of servicing deficiencies.

If the mortgage is sold to another lender that subsequently files a claim for insurance benefits, the lender who signed the indemnification agreement must repay HUD the amount covered by the agreement.

Homeownership and Enforcement Centers are responsible for processing indemnification agreements and the data entry of pertinent indemnification information into HUD systems. The Office of Housing's Claims Branch is responsible for the billing and collection process, once HUD has incurred a loss as defined by the indemnification agreement.

FHA had 5.9 million Single Family Insured properties with a value of \$477.8 billion in its portfolio, as of March 31, 2003. In the six-month period, October 2002 through March 2003, HUD paid 41,701 insurance claims totaling \$3.4 billion. For the same six-month period 33,289 properties were sold at an average net loss of \$23,900<sup>1</sup>.

The total population of indemnified loans recorded in the *Single Family Insurance System – Claims Subsystem*, since inception through March 2003, is 16,324. The status of the loans at the end of March 2003 was: 6,100 active, 4,464 terminated and 5,760 (35%) resulted in claims.

## Audit Objective

Our overall audit objective was to determine if HUD had adequate controls in place to ensure indemnification agreements are adhered to, and the lender reimburses HUD for losses incurred by HUD when a claim is paid.

<sup>1</sup> The profit/loss balance for each case was adjusted to eliminate discounts that were expensed and to reverse receivable activities. See explanation in Finding 1.

### Audit Scope and Methodology

At the Single Family Claims Branch in Headquarters we gained an understanding of the internal controls related to the collection of losses incurred by HUD for indemnified loans that have been submitted for claim. We interviewed HUD staff at the Single Family Claims Branch in Headquarters, Enforcement Center, three Homeownership Centers, Albany Financial Operations Center, and we also interviewed staff at the independent contractor responsible for preparing billing letters. We reviewed indemnified loans during the period January 1, 2000 through March 31, 2003, that had been submitted for conveyance claims where HUD sold the property or non-conveyance preforeclosure sales claims where the borrower sold the property. We also looked at cases with an outstanding receivable balance as of March 31, 2003.

Furthermore, we reviewed the management controls, at three Homeownership Centers we visited, related to the approval and management of lender repayment plans to repay outstanding receivable balances from indemnified loans.

### HUD Data Systems Used

To achieve our audit objective, we analyzed data within HUD's systems. To review the process for tracking and managing indemnified loans, we analyzed data from the *Computerized Housing Underwriting Management System*, *Single Family Accounting Management System*, *Single Family Insurance System – Claims Subsystem*, and the *Single Family Data Warehouse*. We analyzed these systems to identify potential control weaknesses and to estimate the impact of any control weaknesses that we identified. We did not perform a detailed assessment of the reliability of the data within these systems. However, we did perform a minimal level of testing sufficient enough to determine whether the data was reliable enough for our purposes.

We conducted our fieldwork from April 2003 through August 2003.

### Generally Accepted Government Auditing Standards

We conducted the audit in accordance with generally accepted government auditing standards.

# HUD Needs to Ensure Lenders Are Consistently Billed in a Timely Manner

Federal agencies are required to service and collect debts in a manner that best protects the value of the Government's assets. HUD has not consistently billed lenders in a timely manner for monetary sanctions, imposed by the Department, through FHA loan indemnification agreements. HUD needs to bill lenders for losses of \$44.4 million resulting from 1,231 property disposition claims. The Office of Housing's Claims Branch is responsible for tracking properties covered by indemnification agreements and initiating the billing process when property disposition losses occur. The process to identify indemnified property dispositions and associated losses is not automated and requires extensive manual research. Additionally, the following circumstances impacted the billing process: additional research was necessary to determine the actual sales discount, missing copies of the indemnification agreements needed to be located, claims application part B needed to be closed, and a system conversion caused a backlog of agreements. As a result, lenders under indemnification agreements were either not billed or not billed timely to recover property disposition losses. Timely billing increases the likelihood that HUD will recover its losses from indemnified loans and increases the effectiveness of sanctions used by the Department. We recommend that HUD initiate the collection process for cases not billed and enhance systems to fully automate the billing process.

Timely Billing Increases  
the Likelihood of  
Recovery and Protects the  
Value of HUD's Assets

A debt is created when HUD mails the billing letter to the lender. Timely billing increases the likelihood that HUD will recover its losses in accordance with the indemnification agreements. The Office of Management and Budget (OMB) Circular A-129 stipulates that:

*"The Government must service and collect debts in a manner that best protects the value of the Government's assets."*

The Claims Branch  
Initiates the Billing  
Process

The Office of Housing's Claims Branch is responsible for tracking the indemnification and initiating the billing process. The Claims Branch receives two reports that identify claims paid on indemnified loans. HUD can bill the lender when all claim payments have been made and the property has been sold.<sup>2</sup>

<sup>2</sup> Detailed discussion of billing process is in Appendix A.

Information from Several  
HUD Systems Used In  
Our Analysis

We analyzed HUD's data systems to determine whether HUD consistently billed lenders in accordance with active indemnification agreements. After a claim is paid, HUD needs to wait for the property to be sold in order to bill the lender. During our audit period we identified 2,305 property sales where HUD paid a claim on a loan with an active indemnification agreement. It took an average of six months to sell the conveyed properties sold by HUD during our audit period, although some properties took up to three years to sell.

HUD incurred losses of \$81.3 million on 2,225 of the property sales. HUD either made a profit or broke even on the sale of 80 conveyed properties. The average net loss on conveyed property sales with active indemnification agreements was \$35,200. This is significantly higher than HUD's overall average net loss of \$23,900 for all property sales in a six-month period.

We compared the information in the various systems to determine whether HUD billed lenders for its loss within a reasonable period of time.<sup>3</sup>

HUD Needs to Bill  
Lenders for Losses  
Totaling \$44.4 Million

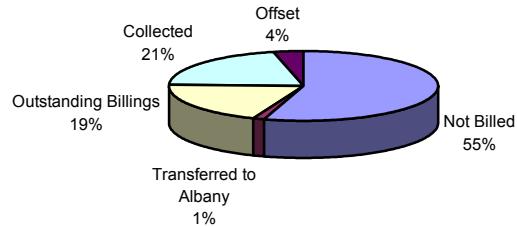
We found that HUD did not consistently bill lenders for losses in accordance with active indemnification agreements. HUD billed lenders to recover losses of \$36.8 million from 994 claims, of which HUD has collected or offset other claims for \$20 million and transferred \$1.2 million to HUD's Albany Financial Operations Center. HUD however, has not billed lenders for losses of \$44.4 million resulting from 1,231 claims.

The table on the next page shows the billing and collection status of the indemnified loans in the population.

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<sup>3</sup> Detailed discussion of data analysis is in Appendix B.

Current Status of Losses from Active Indemnification Agreements  
Period 1/1/00 to 3/31/03



We also found that when lenders were billed, they were not always billed in a timely manner. It took an average of six months to bill lenders for the losses from 590 claims<sup>4</sup>.

Periodically the Staff  
Needs to Keep Manually  
Checking the Systems  
Until Property Is Sold

HUD does not have an automated system for notifying the Claims Branch when it's time to bill a lender. The Claims Branch staff receives two weekly reports identifying when a claim is paid on an indemnified loan. However, if the property has not been sold, the staff needs to retain each weekly report and manually check the system on a periodic basis until all of the properties with claims have been sold. The staff did not always keep track of the conveyed properties that were in the process of being sold. We believe that this is the primary cause for not billing lenders.

The inclusion of preforeclosure sales was recently added to the standard language of the indemnification agreements. The Claims Branch recently did an analysis and identified 130 indemnified cases with preforeclosure sale claims. A staff member was assigned the duty of obtaining the information necessary to bill the 130 claims in March 2003. However, the work was not completed prior to the conclusion of our review.

The Claims Branch stated that the older indemnification agreements did not specify preforeclosure sale claim losses in the language of the agreement. However, the Claims Branch is billing lenders with older agreements for preforeclosure claims. HUD should establish a written billing policy to cover this situation. Furthermore, the Claims Branch advised that there is not a report, like the statement of account, that it

<sup>4</sup> Due to the system conversion, only 590 cases had all of the date fields necessary to do this analysis.

can get out of the system to present to lenders when billing for losses associated with preforeclosure sales claims. HUD should also create a report for losses from preforeclosure sales claims to simplify the billing process.

Furthermore, the Claims Branch advised that there were four other circumstances that impacted the workload.

- 1) Additional research is necessary to determine the actual discount,
- 2) Missing copies of the indemnification agreements need to be located,
- 3) Claims application part B needs to be closed, and
- 4) A system conversion caused a backlog of agreements.

1) Sales Discounts Require Additional Analysis

Sales Discounts Require  
Additional Analysis  
Before Billing

A conveyed property sold with a sales discount necessitates additional staff resources and delays the indemnification billing process. Sales discounts are expensed in HUD's system and affect the profit and loss calculation. Also, when reviewing the discount information in HUD's systems it became apparent that HUD did not have a policy for recording discounts on the Real Estate Settlement Procedures Act Uniform Settlement Statement (HUD-1) or into HUD's systems.<sup>5</sup>

The Claims Branch told us that it would not identify the discount during the billing process if it were not disclosed when the sales offer and acceptance information is entered into the system.

We spoke with staff from both the Claims Branch and the Office of Housing's Single Family Acquired Assets Branch who confirmed that profit and loss amounts computed by HUD's system were sometimes inaccurate because of the way the discounts were recorded in the system.<sup>5</sup>

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<sup>5</sup> Detailed discussion of data analysis and examples is in Appendix B.

HUD-1 Prepared By  
Closing Agent  
Contractors

The discount information is recorded into the system based on how the closing agent contractors prepare the HUD-1. We reviewed the generic contract between HUD and the closing agents and found that there were no instructions on how the closing agent contractors should record discounts on the HUD-1.

Due to the inconsistencies for recording discounts, the Claims Branch needs to perform additional work to research the final discount. This additional workload delays the billing process. In order to bill lenders in a timely manner the billing process should be automated whereby HUD's system computes an accurate loss amount, without the need for human review of the numbers. This would require a consistent process for recording the final discount on the HUD-1 by the closing agent contractors and a change on how the profit and loss amount is computed.

HUD Is Planning to  
Change the Statement of  
Account

The Asset Management and Disposition Division informed us that they are currently in the process of revising the statement of account to show the discount separately from the profit and loss. The system enhancement is planned for next fiscal year. However, to work properly there needs to be a consistent method of accurately recording the discounts.

Furthermore, HUD should consider how receivables from indemnification agreements affect the profit and loss calculation. HUD's loss on the property sale is reduced when the receivable is booked. As discussed in Finding 2, many of these receivables go uncollected or are written-off. HUD has a loss on the sale of these properties until it collects funds either through payment or offset. The profit and loss calculation should be changed to accurately reflect the current status of HUD's loss on sale.

HUD Committed to  
Maximizing the Quality,  
Utility, Objectivity and  
Integrity of Information

The "HUD Final Information Quality Guidelines" were published in the Federal Register on November 18, 2002 and states:

*"The Department of Housing and Urban Development is committed to ensuring and maximizing the quality, utility, objectivity, and integrity of all information it disseminates to the public."*

HUD disseminates loan indemnification information to the public in the *Neighborhood Watch System*. The Office of Housing's Quality Assurance Division put the profit and loss amount into *Neighborhood Watch* but took it out after they learned about the issues previously described. The Quality Assurance Division recently added the field back with the following caveat:

*"The profit/loss may reflect the amount billed on an indemnified loan"*

HUD should be taking steps to disseminate accurate information in the *Neighborhood Watch System* rather than adding a caveat. Not only is it important to have an accurate profit and loss calculation for the billing process, the loss is also relevant to law enforcement when prosecuting crimes involving the property. The statement of account is frequently entered into evidence to show HUD's monetary loss, which could be inflated by the discount or prematurely reduced when a lender is billed.

## 2) A Copy of the Agreement Is Needed to Bill

Agreements Are Needed  
to Bill the Lender After  
HUD Incurs a Loss

HUD needs a copy of the indemnification agreement to ensure the lender is billed in accordance with the agreement.<sup>6</sup> We found that neither the independent contractor nor the Claims Branch had 130 of the 1,231 agreements necessary to bill. Almost all of the missing agreements were processed within the last five years.

The Claims Branch receives a weekly exception report titled "No Hardcopy Documentation Received for Cases by File Number". The report identified cases where Headquarters did not have a copy of the agreement. The first run of this report was on December 21, 2002. Due to the lack of resources the Claims Branch has not utilized the report. Not having these agreements on hand delays the billing process. Furthermore, if the agreements cannot be located, then HUD does not have a basis for the indemnification and should remove the indemnification flag from the system.

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<sup>6</sup> Detailed discussion of indemnification and billing processes is in Appendix A.

On August 14, 2003 the Single Family Post Insurance Division sent system reports to the Quality Assurance Division Directors at the Homeownership Centers, showing indemnified cases for which the Claims Branch did not have copies of the indemnification agreements. They were asked to either provide copies of the agreements or notify the Claims Branch that copies could not be found.

3) Claim Application Form Part B Needs to Be Closed

Claim Application Form  
Part B Needs to Be  
Closed Before Lender  
Can Be Billed

HUD officials advised that the billing process was sometimes delayed because HUD needs to close the claim application form part B before the lender can be billed.<sup>7</sup> We determined that sixty of the 1,231 cases did not have the claims application part B processing closed, as of March 31, 2003. Most of the 60 properties were sold over a year ago.

The Claims Branch advised that there is no statutory deadline for filing Part B of the conveyance claim. HUD should establish a timeframe for indemnification billing purposes that takes this into account and proceed with billing the indemnifying lender for losses, and include a conditional stipulation that additional losses may be billed, pending receipt of the Part B.

4) A System Conversion Caused a Backlog of Agreements

System Conversion  
Caused a Backlog of  
Agreements

HUD officials also advised that the system conversion increased the Claims Branch's workload by causing a backlog of agreements. When the interface was established the Claims Branch received 1,015 cases that were previously not in its tracking system.<sup>7</sup> The system conversion increased the Claims Branch workload by adding 483 cases that needed to be tracked because claims had already been paid. The system conversion accounted for 167 cases of the 1,231 cases that need to be billed.

Summary

HUD has not consistently billed lenders in a timely manner for monetary sanctions, imposed by the Department, through indemnification agreements. HUD needs to bill lenders for losses of \$44.4 million resulting from 1,231 claims. The Claims Branch is automatically notified when a claim is paid

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<sup>7</sup> Detailed discussion of indemnification process and system enhancement is in Appendix A.

on an indemnified loan; however, the Claims Branch is not notified when a property is sold and needs to manually check the system on a periodic basis until it is sold. Due to this manual process, the Claims Branch did not always keep track of the properties that were in the process of being sold. Also, claims arising from preforeclosure sales were in the process of being researched by the Claims Branch when we started our review. When the Claims Branch did keep track of the property disposition status, the property sale was not always identified soon enough to bill the lender in a timely manner.

Additionally, the following circumstances impacted the billing workload: additional research is necessary to determine the actual sales discount, missing copies of the indemnification agreements need to be located, claims application part B needs to be closed, and the system conversion caused a backlog of agreements. Timely billing increases the likelihood that HUD will recover its losses from indemnified loans and increases the effectiveness of sanctions used by the Department. We recommend that HUD initiate the collection process for cases not billed and enhance systems to fully automate the billing process.

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#### Auditee Comments

HUD concurred with the finding and is currently in the process of reconciling the indemnified loss for 1,184 of the 1,231 cases not billed. HUD plans on billing lenders for the indemnified losses by March 31, 2004. HUD located all but 47 missing indemnification agreements. HUD will remove the indemnification flags from these cases.

HUD plans on modifying its systems to automate the billing process by March 1, 2004, subject to the availability of funding. In the interim the Statement of Account has been revised to display any sales discounts separately and further changes will be made to reflect the actual amount of loss to FHA upon disposition of the property. These changes will be in place by January 31, 2004, subject to the availability of funding.

HUD will provide instructions to closing agent contractors by January 31, 2004 to ensure proper and consistent recording of discounts.

OIG Evaluation of  
Auditee Comments

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HUD has initiated taking appropriate actions to ensure that lenders are billed in a timely manner.

Recommendations

We recommend that HUD:

- 1A. Initiate the billing process and collect \$44.4 million from the 1,231 indemnification cases not billed.
- 1B. Enhance systems to the extent possible to:
  - 1) Automate the billing process to bill timely and eliminate the extensive manual research required to bill; and
  - 2) Accurately calculate the current profit and loss on sale amount to eliminate the research needed to properly account for discounts and to reflect the actual status of the loss by reducing the loss *after* funds have been received.
- 1C. Implement policies and procedures to ensure that discounts are consistently and accurately recorded in HUD's systems.
- 1D. Locate missing copies of indemnification agreements or remove indemnification flags from the system.

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# Debt Collection Activities Need Improvement

HUD needs to formulate and implement debt collection policies regarding FHA indemnified loan debt to ensure that the Department is in compliance with the Department of the Treasury's debt collection requirements. Federal agencies are required to promptly act on the collection of delinquent debts, using all available collection tools to maximize collections. Contrary to Treasury's debt collection requirements, HUD's debt collection process did not support active collection of FHA indemnified loan debts. Debts totaling \$15.8 million that had been delinquent 180 days or more were not transferred to Treasury for collection; accrual of interest and penalties on delinquent debt was improperly suspended; and debts delinquent more than 90 days were not properly reported to Treasury. HUD also needs to ensure that all recorded debts are still valid and collectable.

The Office of Housing's Claims Branch that oversees the collection process is primarily responsible for managing all Single Family claim payments, only a small percentage of which are indemnified and require the collection of losses. Housing officials advised that due to workload constraints and the lack of debt collection expertise, the Claims Branch lacked the resources to effectively manage the debt collection process. HUD's debt collection process did not comply with Treasury's intent concerning the administrative offset provision of the Debt Collection Improvement Act. Additionally, HUD's collection process stopped accruing interest on outstanding debt when this debt was placed in a delayed status in the system. In order to facilitate the active collection of debts HUD should impose administrative sanctions by the Mortgagee Review Board against lenders for breaching the indemnification agreement, centralize all collection activities with the Albany Financial Operations Center to the extent possible, add necessary information to the billing letter, implement a process for resolving disputed indemnification amounts, and maintain adequate documentation of all collection activity and decisions.

HUD Required to  
Maximize Collection by  
Ensuring Quick Action to  
Enforce Recovery of  
Debts

In accordance with the Debt Collection Improvement Act of 1996, OMB Circular A-129 requires agencies to promptly act on the collection of delinquent debts, using all available collection tools to maximize collections. Agencies are required to transfer a debt or claim that has been delinquent 180 days or more to Treasury or a Federal debt collection center designated by Treasury. Federal agencies are required to charge interest on delinquent debts and report to Treasury, on a quarterly basis, all delinquent debts.

The Claims Branch is responsible for the debt collection process.<sup>8</sup>

<sup>8</sup> Detailed discussion of debt collection process is in Appendix A.

HUD Needs Fair But  
Aggressive Program to  
Recover Delinquent Debts

We made a preliminary assessment of the aged accounts receivable report and concluded that HUD needed to establish a fair but aggressive program to recover delinquent debts. We reviewed the aged accounts receivable report for the month-end March 2003. The report showed that lenders owed HUD \$21.4 million from 597 indemnified loans. We performed an aging of receivables and found that 431 cases totaling \$15.8 million were over 180 days delinquent. These cases had not been transferred to Treasury as required. Furthermore, 92 cases totaling \$3.7 million were over three years old. There were a few receivables over fifteen years old.

We Tested the Debt  
Collection Process At the  
Claims Branch

We tested the debt collection process by selecting a non-statistical sample of twenty-five delinquent debts for additional review. HUD provided the following information related to our sample selection: the indemnification agreements, billing letters, HUD system screen print-outs related to the billing letters and copies of checks received. This is the extent of available documentation for the HUD indemnification receivables. HUD did not have a system for documenting communications with lenders regarding collection efforts.

HUD needs to ensure that all delinquent debts are valid. We found that in four cases the debt was paid, but HUD's system still showed a balance due. Also, in two cases, HUD may not be able to proceed with legal collection efforts because it could not find the necessary documents to support the debt.<sup>9</sup>

We analyzed the information provided by HUD to determine compliance with debt collection requirements. For our sample, we concluded that HUD billed the appropriate mortgage company in accordance with the indemnification agreement. However, contrary to the Department of the Treasury's debt collection requirements:

- 1) Debt collections need to be actively pursued and debts that are delinquent 180 days or more need to be transferred to Treasury; and
- 2) Interest and penalties on delinquent debt need to be accrued and charged to lenders and

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<sup>9</sup> Detailed discussion of data analysis is in Appendix B.

delinquent debts need to be reported to Treasury.

The Claims Branch staff that oversees the collection process is primarily responsible for managing all Single Family claim payments, of which only a small percentage is related to indemnified loan debts. Due to this workload and the lack of debt collection expertise, the Claims Branch advised that it lacked the resources to properly manage the debt collection process. HUD's debt collection process did not comply with the Treasury's intent concerning the administrative offset provision of the Debt Collection Improvement Act. Furthermore, the Claims Branch did not realize that interest improperly stopped accruing when a receivable was put on a delayed status.

1) Active Collection and Transfer to Treasury

HUD Needs to Actively Pursue Debt Collection and Transfer to Treasury Debts That Are Delinquent 180 Days Or More

HUD needs to aggressively pursue debt collection and refer the debt to Treasury after the debt is delinquent 180 days. Nineteen of the twenty-five cases in our sample were over 180 days old and the debts had not been transferred to Treasury. As previously reported, 431 cases totaling \$15.8 million were over 180 days delinquent, which is over seventy percent of the total delinquent debts on the March 2003 aged accounts receivable report.

Under the debt collection requirements, one of the exceptions for mandatory transfer to Treasury is debt that can be collected by administrative offset within three years. Specifically, it states that the mandatory transfer to Treasury does not apply:

*"to any debt or claim that will be collected under internal offset, if such offset is sufficient to collect the claim within 3 years after the date the debt or claim is first delinquent."*

HUD interpreted this to mean that it could suspend the collection process until such time that HUD could withhold payment(s), equal to the delinquency, from a future insurance claim submitted by the lender. HUD's interpretation however appeared contrary to the purpose of the Act, which states in part:

*“To maximize collections of delinquent debts owed to the Government by ensuring quick action to enforce recovery of debts and use of all appropriate collection tools”*

Treasury Did Not Intend for the Administrative Offset Exception to Be Used to Delay Collection Activities

Waiting three years to offset a future claim is not a prudent action to enforce recovery of debts or a use of all appropriate collection tools. We sought clarification of the administrative offset exception by contacting the Department of the Treasury. We spoke with an attorney with the Financial Management Service Bureau at the Department of the Treasury. According to the Treasury attorney, the administrative offset exception was intended to permit agencies to allow individuals, sufficient time to pay off the debt, for up to three years. Although, the debt is older than 180 days, the debtor is making payments on the debt. The attorney stated that Treasury's position has always been to collect the debt and not to suspend collection activities.

The Treasury attorney advised that the agency should continue collection efforts that include the transfer of the debt to Treasury in 180 days. If an administrative offset does occur at a later time, it would be an administrative matter to reconcile the amount paid on the debt and the offset, refunding the overage to the debtor. If the debtor does not pay the debt or enter into a payment agreement and the debt is over 180 days delinquent, it should be referred to Treasury for collection.

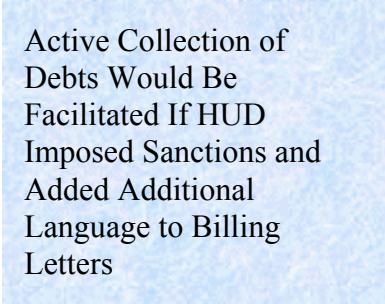
Claims Branch Does Not Actively Pursue Delinquent Debt Collection

Under HUD's current debt collection process, the Claims Branch does not actively pursue delinquent debts.<sup>10</sup> The Claims Branch staff lacks the resources and expertise to effectively manage the collection process. If the lender does not pay the debt, HUD waits to offset a future claim that is submitted by the indemnified lender. The Claims Branch periodically reviews the delinquencies and if they determine that the debt is uncollectible, usually because the lender is out of business, the debt is referred to the Albany Financial Operations Center. After the debt is received by the Albany Financial Operations Center, HUD starts the 180-day period. This process is essentially backwards. The 180-day period should start after the due date of the payment, which is thirty days after the date of the billing letter.

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<sup>10</sup> Detailed discussion of debt collection process is in Appendix A.

HUD needs to aggressively pursue debt collection and refer the debt to Treasury after the debt is delinquent 180 days. In order to comply with the debt collection requirements, HUD needs to send the debt immediately to the Albany Financial Operations Center. The Financial Operations Center already has experience managing debt collections due from individuals who participated in the Single Family Title 1 program. The Albany Financial Operations Center uses the *Debt Management Collection System* to manage the debt collection process. This system is already set-up to process debts arising from loan indemnifications. Ideally, the Albany Financial Operations Center should send the billing letter and track the debt from the beginning. The Albany Financial Operations Center could use all appropriate collection tools available to them to collect the debt. If HUD does not collect the debt after 180 days, the debt should be transferred to Treasury.



Active Collection of Debts Would Be Facilitated If HUD Imposed Sanctions and Added Additional Language to Billing Letters

Encouraging lenders to promptly pay these debts would be facilitated if the Mortgagee Review Board imposed administrative sanctions against lenders for nonpayment. The indemnification agreement stipulates that any material breach of the agreement shall constitute independent grounds for the imposition of administrative sanctions by the Mortgagee Review Board. There is currently not a process<sup>11</sup> for imposing administrative sanctions for nonpayment, which usually constitutes a material breach of the agreement.

Imposing administrative sanctions, like suspending the lender from the Single Family program, may encourage lenders to pay the debt and show that HUD is serious about holding lenders accountable for sanctions imposed by the Department.

Also, to facilitate the active collection of debts HUD should:

- Centralize all collection activities;
- Add necessary information to the billing letter;
- Implement a process for resolving disputed indemnification amounts; and

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<sup>11</sup> Detailed discussion of debt collection process is in Appendix A.

- Maintain adequate documentation of all collection activity and decisions.<sup>12</sup>

2) Accrual of Interest and Quarterly Report to Treasury

HUD Needs to Ensure  
Interest and Penalties Are  
Charged on Delinquent  
Debt

HUD needs to ensure that interest and penalties are charged on indemnified debt. United States Code Title 31, Section 3717 states that the:

*“agency shall charge a minimum annual rate of interest on an outstanding debt on a United States Government claim owed by a person that is equal to the average investment rate for the Treasury tax and loan accounts”*

If the Claims Branch enters a delay transaction code into the system, the accrual of interest and penalties is suspended. The Claims Branch told us that there were several reasons for putting a receivable on delay:

- 1) The debt was placed on delay in preparation for retrieving related documents and shipping it off to the Albany Financial Operations Center for cross servicing. In some instances, original billing information cannot be located, so the referral languishes for lack of documents.
- 2) The mortgagee is paying off the debt under a repayment plan. The repayment plans negotiated by the Homeownership or Enforcement Centers includes interest and penalties. The Claims Branch puts the receivable on delay to avoid the accrual of additional amounts.
- 3) The lender disputes the indemnification amount.

The Claims Branch has referred thirteen cases to the Albany Financial Operations Center, between January 2002 and June 2003. To date, the only time a debt is referred to the Financial Operations Center is when it is determined that the debt is uncollectible. The first reason cited above by the Claims Branch is the main reason for putting debts on delay. However, putting cases on delay while preparing to refer the case to the Albany Financial Operations Center is not a valid reason for suspending the accrual of interest.

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<sup>12</sup> Detailed discussion of additional steps to facilitate debt collection is in Appendix C.

We identified a total of seven payment plans at three Homeownership Centers. There should only be a few instances where putting a debt on delayed status is justified. We reviewed the transaction history from the *Accounts Receivable Subsystem* for the 25 cases in our sample. All twenty-five cases were on delay and the accrual of interest was suspended. We analyzed the status of the 597 cases on the aged accounts receivable report for the month-end March 2003 and found that 549<sup>13</sup> of the cases had been put on delayed status. The 48 remaining cases were delinquent for less than 60 days.

HUD is effectively waiving interest on these delinquent debts for the period a case is on delay. Interest should not be waived.

#### HUD Needs to Ensure Delinquent Debt Is Reported to Treasury

Putting the cases on delay also affects the quarterly Report on Receivables Due From the Public that HUD sends to Treasury. The delay status keeps these debts from being reported to Treasury. In the first quarter of 2003, HUD reported to Treasury almost \$4 million of delinquent debts less than 90 days old. HUD reported zero delinquent debts over 90 days old, although 22 of the cases in our sample were over 90 days old. Furthermore, based on the aging of receivables, 431<sup>13</sup> cases totaling \$15.8 million were over 180 days delinquent.

The Claims Branch told us that the system did not show any cases over 180 days old because the former FHA Comptroller mandated that all delinquent debts were to be transferred to the Albany Financial Operations Center so that Section B of the Report on Receivables Due From the Public that it sends to Treasury would show a zero balance. The Claims Branch stated that this was a verbal mandate and could not specify when it occurred. As previously discussed, the Claims Branch interpreted the requirements to mean it could wait three years for an administrative offset, which is why HUD kept the debt past 180 days. Prior to the mandate by the former Comptroller, the Claims Branch transferred delinquent debt at three years and those cases appeared in the Debt Eligible for Referral to Treasury for Offset amount of the quarterly report.

<sup>13</sup> This includes cases under payment plans. The system cannot identify which cases have payment plans.

Putting the delinquent debts on delayed status suspends the accrual of interest and keeps the debts off of the quarterly report to Treasury. The Claims Branch did not intend on suspending the accrual of interest. The Claims Branch stated that the interest that should have accrued after a receivable is put on delay status is added to the balance when the delay is removed. However, we found that the system only adds back the interest and penalties accrued before the delay. HUD needs to continue charging interest on delinquent debts and it needs to report all delinquent debts to Treasury.

### Summary

Contrary to the debt collection requirements, documents did not support active collection of the debt; debts that had been delinquent 180 days or more were not transferred to Treasury; accrual of interest and penalties on delinquent debt was suspended; and delinquent debts were not properly reported to Treasury. HUD also needs to ensure that all delinquent debts are valid.

The Claims Branch staff that oversees the collection process is primarily responsible for managing all Single Family claim payments, of which only a small percentage is indemnified. Due to this workload and the lack of debt collection expertise, the Claims Branch lacked the resources to properly manage the debt collection process. HUD program manager's also misinterpreted the Department of Treasury's intent concerning the administrative offset provision of the Debt Collection Improvement Act. Furthermore, the Claims Branch did not realize that interest wasn't accrued, for the period a receivable was on a delayed status.

HUD needs to formulate and implement policies to ensure that the Department is in compliance with the Debt Collection requirements. Also, to facilitate the active collection of debts HUD should impose administrative sanctions by the Mortgagee Review Board against lenders for breaching the indemnification agreement, centralize all collection activities with the Albany Financial Operations Center to the extent possible, add necessary information to the billing letter, implement a process for resolving disputed indemnification amounts, and maintain adequate documentation of all collection activity and decisions.

Auditee Comments

HUD concurred with the finding and plans on transferring all activity concerning billing and collection of indemnification agreements to the Albany Financial Operations Center by March 31, 2004. As part of the transfer, FHA will refer all cases over 180 days delinquent to Treasury by December 31, 2003.

The Financial Operations Center will routinely report those institutions that are unresponsive to HUD's demand letters to the Enforcement Center, which will refer those institutions to the Mortgagee Review Board for administrative sanctions as appropriate.

Billing and demand letters will be modified to include all necessary debt collection information language by December 31, 2003.

The Financial Operations Center will implement necessary documentation and retention rules for indemnification processing by June 30, 2004.

FHA will research all delinquent debts over 180 days old to determine whether the debt is valid and enforceable or should be written off, by March 31, 2004.

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OIG Evaluation of  
Auditee Comments

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HUD plans on taking appropriate actions to improve debt collection activities.

Recommendations

We recommend that HUD:

- 2A. Formulate and implement policies to ensure that the Department is in compliance with the Debt Collection requirements. Specifically, HUD needs to:
  - 1) Transfer debt delinquent 180 days or more to Treasury, including 431 cases totaling \$15.8 million that were over 180 days delinquent on March 31, 2003;
  - 2) Ensure that interest and penalties are accrued on all eligible debt; and

- 3) Properly disclose delinquent debts on the quarterly report to Treasury.
- 2B. Actively pursue collection of delinquent debts by:
  - 1) Imposing administrative sanctions by the Mortgagee Review Board against lenders for breaching indemnification agreement;
  - 2) Centralizing all collection activities with the Albany Financial Operations Center to the extent possible and maximize the use of all available collection tools;
    - A) If debt collection is not centralized then HUD needs to establish adequate handling and protecting cash and negotiable instruments management controls at the Homeownership Centers.
  - 3) Adding necessary information to billing or demand letter;
  - 4) Implementing a process for resolving disputed indemnification amounts;
  - 5) Establish procedures to document collection activity, including bases for decisions, and maintain documentation for a reasonable period of time.
- 2C. Research delinquent debts to ensure all debts are valid.

# Internal Controls for Processing Indemnification Agreements Can Be Improved

HUD is committed to ensuring and maximizing the quality, utility, objectivity and integrity of information it disseminates to the public. We found that data in the HUD systems for the indemnification agreements in our sample was generally complete and reliable. However, we did identify control weaknesses that allowed data errors to get into the systems. The HUD Quality Assurance Division has not formulated policies or procedures related to the internal indemnification processing outside of the data entry into the *Computerized Home Underwriting Management System*. The lack of current policies and procedures contributed to processing inconsistencies or misunderstandings resulting in errors. Consequently, inaccurate indemnification agreement information may get into HUD systems that can delay the billing process or lapse the indemnification period earlier than intended. We recommend that HUD formulate policies and procedures for processing indemnification agreements to address the identified weaknesses.

HUD Committed to  
Maximizing the Quality,  
Utility, Objectivity and  
Integrity of Information

The “HUD Final Information Quality Guidelines” were published in the Federal Register on November 18, 2002 and states:

*“The Department of Housing and Urban Development is committed to ensuring and maximizing the quality, utility, objectivity, and integrity of all information it disseminates to the public.”*

HUD disseminates loan indemnification information to the public in the *Neighborhood Watch System*. Furthermore, during our interim discussions with HUD Single Family management, the Acting Deputy Assistant Secretary for Single Family Housing stressed the importance of getting the right information into the systems.

Quality Assurance  
Division and Enforcement  
Center Enter  
Indemnification  
Information into System

After the indemnification agreement is processed, the Quality Assurance Division or Enforcement Center enters the indemnification information into HUD’s systems.<sup>14</sup>

<sup>14</sup> Detailed discussion of indemnification process is in Appendix A.

Indemnification Data Is Generally Complete and Reliable

We performed two tests of the data entry of indemnification information into the system to determine whether there were adequate management controls to ensure complete and reliable indemnification agreement data was entered into the system. We tested agreements that were entered into the system after the September 2002 system update.<sup>15</sup>

If the Single Family Claims Branch receives an indemnification agreement that is not entered into the system, it notifies the Homeownership Center that the agreement needs to be entered. Under the current process the only way an indemnification agreement will not get recorded is if the agreement is not entered into the system and not received by the Claims Branch.

We tested the completeness of the indemnification agreement information by reviewing 811 cases to determine whether indemnified loans are consistently flagged in HUD's systems. Two of the Homeownership Centers maintained independent systems whereby we could identify all indemnifications processed. We selected all of the loans indemnified within a specific period by the Homeownership Centers to determine whether these cases were flagged in the system.

Next, we tested the reliability of indemnification information entered into the system by reviewing the data entry for 154 cases from three of the four Homeownership Centers. The Enforcement Center had just begun entering the indemnification information into the system so we did not include the site in our sample.

Policies and Procedures for Processing Indemnification Agreements Would Improve Controls

We found that data in the HUD systems for the indemnification agreements in our sample was generally complete and reliable. However, we did identify control weaknesses that allowed data errors to get into the systems.

The Quality Assurance Division is currently in the process of updating its internal indemnification processing procedures, outside of the instructions for data entry into the *Computerized Housing Underwriting Management System*. However, the lack of current policies and

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<sup>15</sup> Detailed discussion of data analysis is in Appendix B.

procedures may have caused inconsistencies or misunderstandings that resulted in errors. For example, staff at one of the Homeownership Centers entered the wrong agreement date into the system for twenty-three cases. The staff used the date the lender signed the agreement as the agreement date. However, the agreement date is the date that both parties have signed the agreement, which was the date the Quality Assurance Director signed it.

In another example, Quality Assurance staff was unsure about the refinance indicator entry. The staff enters into the system a “yes/no” flag that indicates whether the indemnification agreement is transferable to a future streamline refinance. The flag is defaulted to “yes” in the system. We found twelve cases from two agreements with errors during our pre-site audit work, where the “no” flag was improperly used, but further analysis showed that these were isolated incidents. We asked staff that entered indemnification information into the system when it was appropriate to change the streamline refinance flag to “no” and the staff did not know the circumstances when the flag should be changed. The Quality Assurance Division in Headquarters informed us that the flag is only changed when the indemnification is the result of a servicing lender review. The indemnification may be dropped earlier than intended if the wrong streamline refinance flag is entered into the system. Written internal indemnification processing policies and procedures may have prevented the errors shown in the last two examples.

#### Independent Verification of Data Entry Would Also Improve Controls

An independent verification of the data entry could also help minimize errors. We found twenty-six instances where the incorrect mortgagee to bill, loan originator identification number, or sponsor identification numbers were entered into the system. There was one case where the wrong case number was printed on the indemnification agreement but it was entered correctly into the system. Also, one case had the expiration date based on the agreement date rather than the endorsement date, however there was no effect since it had a thirty-year term. Entering the wrong information into the system may delay the billing process, while the staff researches the matter.

A Quality Assurance Director recently began having the staff enter the information into the system and printout the input

screen so the Director could verify the data entry before signing the agreement. Ideally the information should be verified after the agreement is signed. System controls would be improved if supervisors or independent staff at the Homeownership or Enforcement Centers verifies that the information from the indemnification agreement agrees with the lender review file documentation and was correctly entered into the system.

### Summary

We found that data in the HUD systems for the indemnification agreements we tested was generally complete and reliable. However, we did identify several control weaknesses that allowed data errors to get into the systems. Quality Assurance has not formulated policies or procedures related to the internal indemnification processing outside of the data entry into the *Computerized Home Underwriting Management System*. The lack of current policies and procedures may have caused processing inconsistencies or misunderstandings resulting in errors. Consequently, inaccurate indemnification agreement information may get into HUD systems that can delay the billing process or drop the indemnification earlier than intended. We recommend that HUD formulate policies and procedures for processing indemnification agreements to address the identified weaknesses.

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### Auditee Comments

HUD concurred with the finding and FHA will issue policies and procedures by December 31, 2003 to the Homeownership and Enforcement Centers for processing indemnification agreements including handling and protecting cash and negotiable instruments. In addition by June 30, 2004 the Albany Financial Operations Center will implement controls to verify the accuracy of indemnification information keyed into CHUMS as well as ensure that paper copies of indemnification agreements are received for all indemnified cases.

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### OIG Evaluation of Auditee Comments

HUD plans on taking appropriate actions to improve internal controls for processing indemnification agreements.

**Recommendations**

We recommend the Quality Assurance Division:

- 3A. Formulate and implement policies and procedures, related to the processing of indemnification agreements, used by the Homeownership and Enforcement Centers to ensure and maximize the quality, utility, objectivity and integrity of indemnification information. These policies and procedures should include independent verification of the data entry to ensure that the information is valid; and should address inconsistencies or misunderstandings described in the report concerning agreement dates and the refinance indicator.

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# Issues Needing Further Study and Consideration

During our review we noted an additional issue that warrants HUD's consideration and possible action. We found instances where the indemnification did not follow the loan when it was streamline refinanced. HUD should research its processes and procedures to ensure that all loans that are streamline refinanced and still covered by an indemnification agreement are flagged in the *Single Family Insurance System – Claims Subsystem*.

## Additional Procedures Are Needed to Ensure Indemnifications Transfer to a Streamline Refinance

The Department enhanced its systems in December 2002 to transfer the indemnification to a new loan that has been streamline refinanced. The system automatically transfers the indemnity when the new case number for the streamline refinance is established after the original loan was flagged in the *Single Family Insurance System – Claims Subsystem* and the streamline refinanced loan is endorsed.

When an indemnification agreement is processed by the Homeownership Center, the staff checks the *Neighborhood Watch System* to see if the case has been streamline refinanced. A streamline refinance is reported in *Neighborhood Watch* a month after the loan is endorsed. If the loan has already been streamline refinanced the new case number is used when processing the indemnification agreement and the refinanced loan is flagged in the system.

We tested loans indemnified after the system enhancement to determine whether streamline refinanced cases, still covered by an indemnification from the original case, were automatically flagged in the *Single Family Insurance System – Claims Subsystem*. We found several instances where the indemnification did not follow the loan when it was streamline refinanced. In these cases, the new case number had been established but the streamline refinance had not been endorsed, when the original loan was indemnified. Since the refinanced loan was not endorsed it would not have shown up in *Neighborhood Watch* when the staff checked. Therefore the current processes and procedures will not flag a streamline refinance if the new loan is in process when the original loan is indemnified.

## Potential Solutions to Correct the Problem Need to Be Researched

There is not an easy solution to correct the problem. HUD needs to research the issue to formulate workable processes and procedures. One possible solution is to have the Homeownership Center check to see if a streamline

refinance is in process, however there is not an easy way to do this. A loan can be streamline refinanced by any lender, so the indemnified lender may have no idea that the loan is being refinanced. The staff can check the *Computerized Home Underwriting Management System*. However, if the new lender does not enter the property information into the system the same way the original lender did, then it may be difficult for the staff to identify a new loan that is in process. The borrower can be questioned but it may be difficult to contact the borrower or the borrower may be unwilling to cooperate. Another possible solution is to enhance the system to trigger the transfer of the indemnification after HUD endorses the loan being streamline refinanced and puts it in Neighborhood Watch.

# Management Controls

In planning and performing our audit, we considered the management controls over the process of tracking, billing and collecting monetary sanctions from lenders, in accordance with indemnification agreements, to determine our auditing procedures, not to provide assurance on the 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.

## Relevant Management Controls

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

- Program Operations – Policies and procedures that management has implemented to reasonably ensure that a program meet its objectives.
- Safeguarding Resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss and misuse.
- Validity and Reliability of Data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

## Assessment Procedures

We assessed the relevant management controls identified above to obtain an understanding of management controls relevant to the audit by performing the following assessment procedures. We analyzed data from the *Computerized Housing Underwriting Management System*, *Single Family Accounting Management System*, *Single Family Insurance System – Claims Subsystem*, and the *Single Family Data Warehouse*. We interviewed HUD staff at the Single Family Claims Branch in Headquarters, Enforcement Center, three Homeownership Centers, Albany Financial Operations Center, and we also interviewed staff at the independent contractor responsible for preparing billing letters.

We reviewed indemnified loans during the period, January 1, 2000 to March 31, 2003, that had been submitted for conveyance claims where HUD sold the property or non-conveyance preforeclosure sales claims where the borrower

sold the property, to determine whether lenders were consistently billed in accordance with indemnification agreements. We also reviewed cases with an outstanding receivable balance as of March 31, 2003 to determine whether HUD was following the debt collection requirements.

At two Homeownership Centers, we reviewed the completeness of indemnifications agreements getting into the systems. At three Homeownership Centers we reviewed the data entry of indemnification agreements into HUD systems to determine the accuracy of indemnification recorded in the system. Furthermore we reviewed the processes, used by the Homeownership Centers to approve and manage lender repayment plans used to pay down outstanding receivable balances from indemnified loans.

### Significant Weaknesses

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:

- Program Operations

HUD management controls need to be improved to ensure that the Single Family program meets the objective of collecting monetary sanctions, imposed by the Department, from lenders in a timely manner. The Department loses the effectiveness of sanctions used to improve lender performance if lenders are not held accountable for fulfilling their commitments under the indemnification agreements.

- Safeguarding Resources

HUD management controls need to be improved to ensure the Department services and collects debts in a manner that best protects the value of the Government's assets. The chances for collecting debts arising from indemnification agreements diminishes when the Department does not bill lenders in a timely manner, does not actively make collection efforts and does not refer the debt to Treasury after the debt is delinquent over 180

days. Furthermore, management controls need to be improved at the Homeownership Centers to ensure that collections from lenders are adequately safeguarded.<sup>16</sup>

- Validity and Reliability of Data

HUD management controls need to be improved to ensure that indemnification, sales discount and profit/loss on sale information maintained in its systems is valid and reliable. If HUD systems contain inaccurate indemnification agreement information, the billing process can be delayed or the indemnification can be dropped earlier than intended. If HUD systems contain inaccurate discount and profit/loss on sale information the billing process can be delayed, lenders can be billed the wrong amount, and law enforcement officials may rely on the wrong loss amount.

These weaknesses are more fully described in the findings section of this report.

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<sup>16</sup> Detailed discussion of management controls for collections at the Homeownership Centers is in Appendix C.

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## Follow Up On Prior Audits

We performed a prior audit of the loan indemnification process in 1992. There are no open recommendations associated with this audit.

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# HUD Processes and Procedures

## Indemnification Process

An indemnification agreement is a tool used by HUD to sanction lenders who commit some kind of irregularity, either through fraud or a violation of HUD policies and procedures in originating or servicing a mortgage that has been insured by HUD. If the error is detected prior to insurance, endorsement is denied until the problem is resolved; if the loan is already insured, HUD will initiate the indemnification process.

Homeownership and Enforcement Centers are responsible for processing indemnification agreements and the data entry of pertinent indemnification information into HUD systems. The Quality Assurance Division within each Homeownership Center may negotiate an indemnification agreement when performing a lender review. After the lender signs the agreement it is forwarded to the Director of the Quality Assurance Division for signature. The quality assurance staff at the Homeownership Centers enters the indemnification agreement information into the *Computerized Housing Underwriting Management System*.

The *Computerized Housing Underwriting Management System* was enhanced to allow the input of additional indemnification information to improve the tracking and management of indemnified loans. The system update was rolled out in September 2002.

HUD established an interface between the *Computerized Housing Underwriting Management System* and the *Single Family Insurance System – Claims Subsystem*. The *Claims Subsystem* manages the payment of insurance claims. The interface automatically flags the indemnified loan in the *Claims Subsystem*. Prior to the interface the independent contractor or the Claims Branch would flag the case in the *Claims Subsystem* after it received a copy of the agreement from the Homeownership or Enforcement Centers. The interface between the two systems became operational in December 2002.

In some cases the Quality Assurance Division refers the lender to the Mortgagee Review Board, which is supported by the Enforcement Center. The Mortgagee Review Board may also require the lender to indemnify a loan in the settlement agreement. The Enforcement Center is responsible for entering the indemnification information into the system.

In the terms of the indemnification agreement the lender may agree that if a claim is filed, the claim will be reduced by a specific dollar amount, or the lender may agree to forego filing an insurance claim for a specific period of time or for the life of the loan. Typically the period of time used by HUD in the indemnification agreements is five years. However, under certain conditions, such as property defects or delinquent payments prior to endorsement, the lender may be required to indemnify HUD throughout the life of the loan. If there is a streamline refinance of the loan during the indemnification period, the indemnification agreement will automatically follow the new loan in system if the agreement was a result of origination deficiencies. The indemnification agreement will not follow a streamline refinance if the agreement was the result of servicing deficiencies.

## Appendix A

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When an indemnification agreement is processed by the Homeownership Center, the staff checks the *Neighborhood Watch System* to see if the case has already been streamline refinanced. A streamline refinance is reported in *Neighborhood Watch* a month after the loan is endorsed. If the loan has already been streamline refinanced the new case number is used when processing the indemnification agreement and the refinanced loan is flagged in the system.

Lenders agree to indemnify HUD for losses that may be incurred on any FHA case stipulated in the indemnification agreement. The amount of indemnification is HUD's investment in the property minus the sales price of the property. HUD's investment includes, but is not limited to, the full amount of the insurance claim actually paid; any loss mitigation partial claims; all taxes and assessments; all maintenance and operating expenses; all sales expenses; and any other expenses HUD may incur with respect to the property. After the close of the contract of sale, HUD can calculate the amount of indemnification.

The original indemnification agreement is filed in the lender review file and stored at the Homeownership Center. The quality assurance staff enters summary information, including the number of indemnified loans and the date the agreement was mailed to the Claims Branch, into the *Approval/Recertification/Review Tracking System*.

After the indemnification agreement is processed by the Homeownership Center, it mails a copy of the agreement to the Claims Branch. The Claims Branch used to maintain the indemnification agreements but delegated the duty to an independent contractor. HUD sent all of the agreements, except those processed by the Enforcement Center, to the independent contractor in January 2000. Either the contractor or the Claims Branch enters the received date into the *Single Family Insurance System – Claims Subsystem* when an agreement is received.

### **Billing Process**

Once HUD has incurred a loss as defined by the indemnification agreement, the Office of Housing's Claims Branch is responsible for tracking the indemnification, initiating the billing process and collecting the debt.

A conveyance occurs when the lender obtains the property after mortgage default through foreclosure or by deed-in-lieu and deeds the property to HUD. If the loan was sold the conveyance claim is paid to the holder of the loan and HUD bills the lender who signed the agreement. HUD will withhold paying the conveyance claim, if the lender who signed the indemnification agreement subsequently submits a claim on a loan it kept in its loan portfolio.

The property is not conveyed to HUD if the borrower, participating in the loss mitigation program, sells the property in a preforeclosure sale. HUD will pay a claim if the sale proceeds are less than the amount owed.

The staff receives two weekly reports from the *Single Family Insurance System – Claims Subsystem* that identifies indemnified loans where a claim has been paid. The New Indemnity Transactions report shows all of the cases that were indemnified during the week of the report. The report also identifies whether a claim has already been paid on any of the cases. The

Indemnity – PMF Claims Paid Batch Update report shows cases where HUD paid an insurance claim on a loan that was indemnified.

Once an insurance claim has been paid on an indemnified loan, the Claims Branch has to periodically go into the system and manually check to see if the properties that are listed on each weekly report have been sold.

HUD has to verify that all insurance claims on the property are paid before the lender can be billed. The application form submitted by lenders for insurance benefits consists of five parts. HUD makes claim payments based on part A and B of the application. The other parts provide supporting documentation. Part A is the initial application and provides the initial case data. Part A contains information relating to the mortgage, property, property condition, mortgagee, payment history and the foreclosure or assignment process. Part B contains fiscal data consisting of allowable expenses and accrued interest. It provides summary information relating to receipts and disbursements by the mortgagee, which affect the amount of the insurance claim.

In order to determine the full loss on an insurance claim both parts A and B need to be processed and closed. The system may prevent a part B claim payment if the loan was indemnified after the part A was processed but before the part B was processed. If the Part B has errors or has not been submitted by the lender, then additional research is needed before the part B can be closed.

When the Claims Branch ascertains that the property has been sold and all claims on the property have been paid, it prints out a Statement of Account and the Offer Acceptance Query screen from the *Single Family Accounting Management System*. The statement of account identifies HUD's loss on the sale and the offer acceptance query screen identifies any sales discounts. Additional research is required to ascertain the actual discount on the sale. Sales discounts are expensed on the statement of account. The Claims Branch adds back the discount thereby reducing the loss calculated on the statement of account.

A copy of the statement of account is forwarded to an independent contractor, who maintains copies of the indemnification agreements. The independent contractor pulls the indemnification agreement and prepares the billing letter. The billing letter is sent to the HUD Claims Branch for signature. HUD mails the billing letter, indemnification agreement and statement of account to the lender. The Claims Branch retains the settlement agreements processed by the Enforcement Center and prepares the billing letters for these cases.

### **Collection Process**

The billing letter instructs the lender to send the payment, with a copy of the billing letter, to the HUD lockbox in St. Louis within 30 days. The indemnification agreement stipulates that any material breach of the agreement shall constitute independent grounds for the imposition of administrative sanctions by the Mortgagee Review Board.

When the billing letter is sent, a system generated dunning letter is also mailed. If HUD does not receive payment, additional dunning notices are sent after 30 days and 60 days. The language of the first dunning letter is similar to the billing letter and the amount due in the subsequent

## Appendix A

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dunning letters includes accrued interest and penalties. If payment is still not received, then the Claims Branch will offset a future claim submitted by the lender.

Occasionally a lender seeks an installment repayment plan due to a hardship. The lender is referred to one of the Homeownership Centers or the Enforcement Center, where the hardship is verified and the repayment plan is negotiated. Mortgagee Review Board dockets often includes payment plans too. The Board's practice is to establish terms of repayment and formalize in the signed settlement agreement (docket).

Once the Claims Branch establishes a debt in the *Accounts Receivable Subsystem of the Single Family Insurance System – Claims Subsystem*, interest and penalties are automatically accrued every 35 days after the debt becomes delinquent. If the Claims Branch enters a delay transaction code into the system, the accrual of interest and penalties is suspended.

The Claims Branch submits a monthly aged accounts receivable report to the Enforcement Center. The report primarily consists of debts due from lenders for indemnified loans. When a settlement agreement is being processed, the Enforcement Center checks the aged receivable report and seeks payment of any unpaid indemnification losses in the new agreement.

When the Claims Branch determines that a debt is uncollectible, the debt is referred to HUD's Financial Operations Center. The Financial Operations Center reinitiates the collection process and sends a demand letter. If HUD does not receive payment from the second demand letter, a dunning notice is sent every 30 days. The debt is transferred to Treasury for additional collection efforts or write-off 180 days after the Financial Operations Center receives the debt from the Claims Branch.

### **Process for Recording Discounts**

The discount information is entered into the *Single Family Acquired Asset Management System* during the disposition process in two different places, the Offer/Acceptance screen and the HUD-1 screen. HUD, through a Management and Marketing (M&M) contractor, manages and sells single-family homes conveyed to HUD. The M&M contractor negotiates the sale with the buyer and once a sales contract is signed, enters the pertinent information into the Offer/Acceptance screen. The discount, which may include closing fees or additional volume discounts, is not finalized until the sale is closed. To complete the sales of the properties, HUD utilizes the services of closing agent contractors to perform all necessary closing activities on its behalf. When the sale is closed, the closing agent completes the Uniform Settlement Statement (HUD-1). The M&M contractor enters the pertinent information from the HUD-1 into the HUD-1 screen.

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# Analysis of Information in HUD Systems

## **Tested Completeness of Indemnification Flags**

We tested the completeness of the indemnification agreement information to determine whether indemnified loans are consistently flagged in HUD's systems. We tested agreements that were entered into the system after the September 2002 system update. Two of the Homeownership Centers maintained independent systems whereby we could identify all indemnifications processed.

To test for completeness, we performed 100% testing of agreements we identified from independent systems maintained by two Homeownership Centers for a short period of time. We found that data in the HUD systems for the indemnification agreements that we tested was generally complete. We tested 811 indemnified loans and found five instances where the information was not in the system.

One of the Homeownership Centers created a table in Excel to track all of its indemnification agreements. We tested the completeness of cases in the systems by matching 248 cases on the Excel table, for the period October 1, 2002 to April 30, 2003. We found that all but three were in the systems or were in the process of being loaded into the systems. Also, the Homeownership Center was in the process of testing the ability to upload 102 cases from an electronic database table directly into the *Computerized Housing Underwriting Management System*.

Another Homeownership Center keeps a copy of all of its agreements maintained by fiscal year. We tested the completeness of cases in the systems by matching 563 cases in the January through March 2003 files. All of the agreements were entered into the systems, except for two cases that had not been entered because the cases had already been archived in the *Computerized Housing Underwriting Management System*. After the cases were restored, the indemnification agreement information for each case was entered.

## **Tested Reliability of Indemnification Information**

We tested the reliability of indemnification information entered into the system by reviewing the data entry for 154 cases from three of the four Homeownership Centers. The Enforcement Center had just begun entering the indemnification information into the system so we did not include the site in our sample.

We selected a non-statistical sample of seventeen lender review files for examination at three of the Homeownership Centers to test the reliability of the indemnification data. The seventeen lenders agreed to indemnify 154 loans as part of these reviews. We verified the indemnification information that was entered into the *Computerized Housing Underwriting Management System* for these loans by reviewing the documentation in the lender review files. We also verified whether the indemnification information properly transferred to the *Single Family Insurance System – Claims Subsystem*.

## Appendix B

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We found that data in the HUD systems for the indemnification agreements in our sample was generally reliable. However, we did identify control weaknesses that allowed data errors to get into the systems.

For example, staff at one of the Homeownership Centers entered the wrong agreement date into the system for twenty-three cases. The staff used the date the lender signed the agreement as the agreement date. However, the agreement date is the date that both parties have signed the agreement, which was the date the Quality Assurance Director signed it.

In another example, Quality Assurance staff was unsure about the refinance indicator entry. The staff enters into the system a “yes/no” flag that indicates whether the indemnification agreement is transferable to a future streamline refinance. The flag is defaulted to “yes” in the system. We found twelve cases from two agreements with errors during our pre-site audit work, where the “no” flag was improperly used, but further analysis showed that these were isolated incidents. We asked staff that entered indemnification information into the system when it was appropriate to change the streamline refinance flag to “no” and the staff did not know the circumstances when the flag should be changed. The Quality Assurance Division in Headquarters informed us that the flag is only changed when the indemnification is the result of a servicing lender review. The indemnification may be dropped earlier than intended if the wrong streamline refinance flag is entered into the system.

We found twenty-six instances where the incorrect mortgagee to bill, loan originator identification number, or sponsor identification numbers were entered into the system. There was one case where the wrong case number was printed on the indemnification agreement but it was entered correctly into the system. Also, one case had the expiration date based on the agreement date rather than the endorsement date, however there was no effect since it had a thirty-year term. Entering the wrong information into the system may delay the billing process, while the staff researches the matter.

### **Tested Transfer of Indemnification Flag to New Streamline Refinanced Loans**

See Issues Needing Further Study and Consideration for discussion of this test.

### **Adjustment of Calculated Profit and Loss Necessary**

The loss on sale amount obtained from the *Single Family Acquired Asset Management System* does not reflect the actual or original loss and required adjustment. If HUD offers the buyer of the property a discount, the loss on sale is increased by the discount. We eliminated discounts that increased the loss since lenders are not liable for HUD’s discount programs. Additionally, if a lender is billed in accordance with an indemnification agreement, generally the loss on sale is reduced when the receivable is established. Also, other billing activity and adjustments affect the balance. We reversed these deductions to estimate the original loss for informational purposes. HUD’s loss on sale amounts used in this report will include these adjustments.

Of our population of 2,199 conveyed properties tested, 297 property sales included discounts.

We obtained discount data from the *Single Family Acquired Asset Management System* in order to make our adjustments of the profit and loss. When reviewing the Offer/Acceptance and HUD-1 screen data, it became apparent that HUD did not have a policy for recording discounts on the HUD-1. Based on our review of the data from over 29,300 property sales with discounts, we observed multiple methods for recording the discounts on the HUD-1 screen, as follows:

- Thirty-six percent of the cases had the sales price recorded on line 401 of the HUD-1 screen reduced by the discount.
- Eighteen percent of the cases had the discount recorded on line 507 of the HUD-1 screen.
- Two percent of the cases had the discount recorded twice, first on line 507 and then by reducing the sales price recorded on line 401.
- Two percent of the cases had the sales price recorded on line 401 reduced by the discount and partial discounts or allowances on line 507.
- Six percent of the cases had a discount disclosed on the Offer/Acceptance screen but a discount was not recorded in line 401 or 507. The discount for these cases may have been recorded on other lines of the HUD-1 screen.
- Thirty-five percent of the cases had an amount on line 507 but there was not a discount recorded on the Offer/Acceptance screen.

The Claims Branch told us that it would not identify the discount during the billing process if it were not disclosed on the Offer/Acceptance screen.

The particular account used to record the discount expense depends on how the discount is recorded in the systems. We identified three expense categories used to expense discounts: capital expense other, sales expense and sales incentive allowance. Sometimes, the sales discount from one sale is expensed in more than one category.

We spoke with staff from both the Claims Branch and the Office of Housing's Single Family Acquired Assets Branch who confirmed that profit and loss amounts computed by the *Single Family Acquired Asset Management System* were sometimes inaccurate because of the way the discounts were recorded in the system. We obtained several examples of cases that were being researched. In one case the Offer/Acceptance screen showed that the borrower received a ten percent discount. However the HUD-1 screen showed what appeared to be a fifteen percent discount recorded on the settlement charges to HUD on line 502. However, using fifteen percent to calculate the discount left an irreconcilable difference of \$18.

In another case the borrower received a fifty percent discount of \$40,000 on the property sale. On the HUD-1 screen the discount was entered twice under other unpaid items on lines 515 and 517. Thus, discounts equaling the whole sales price were expensed in the system. In both of these examples, the discounts were recorded in other lines on the HUD-1 screen rather than on the purchaser allowance, line 507. In the last example, both the Offer/Acceptance and HUD-1 screens showed a sales price of one dollar. Although, there was obviously a discount on the sale, the bid amount or fair value of the property was not in the system. The Office of Housing's Asset Management and Disposition Division needed to compute an adjusted statement of account for this case so the loss could be determined. It took about two months to get the adjusted statement of account.

Furthermore, the profit and loss calculation is affected by entries into the *Accounts Receivable Subsystem*, when a receivable is established. The loss on the statement of account is reduced when the receivable is booked. As discussed in Finding 2, many of these receivables go uncollected or are written-off. HUD has a loss on the sale of these properties until it collects funds either through payment or offset. We made adjustments to the profit and loss amount to remove the changes caused by the *Accounts Receivable Subsystem* to determine the original loss on sale of the property.

#### **Analyzed Systems to Determine If Lenders Were Billed In a Timely Manner**

An indemnification agreement is active if the default that led to foreclosure occurred before the expiration date of the agreement. We used the *Single Family Data Warehouse* to identify loans with indemnification agreements, the last payment date on the loan and the expiration date of the agreement.

HUD can initiate the billing process after it sells the conveyed property or immediately if the property is sold in a preforeclosure sale. We obtained electronic records from the *Single Family Acquired Asset Management System* for all properties sold within our audit period, January 1, 2000 to March 31, 2003. Using the information from the *Single Family Data Warehouse* we identified 2,221 properties, with active indemnification agreements, that were sold within the audit period. HUD paid claims on 2,199 of the properties. Although HUD withheld paying the claim on 22 of the properties, these properties still went through the process of being conveyed to and sold by HUD. HUD implemented additional procedures about a year ago to help eliminate this problem.

We used the *Single Family Data Warehouse* to identify loans with indemnification agreements that had a preforeclosure claim payment. During the audit period, HUD paid preforeclosure claims on 106 properties.

We estimate that 52%<sup>17</sup> of the time, the conveyance claims were already processed before the indemnification agreements were signed. It took an average of six months to sell the 2,199 properties, although some properties took up to three years to sell.

HUD incurred losses of \$81.3 million on 2,119 of the 2,199 properties sold and from 106 preforeclosure sales. HUD either made a profit or broke even on the sale of 80 conveyed properties. The average net loss on the 2,199 loans was \$35,200.

We obtained electronic records from the *Accounts Receivable Subsystem of the Single Family Insurance System – Claims Subsystem* for all transactions with an indemnities reason code to identify the billing, collection and write-off activity for indemnified loans. We extended the cut-off date for these transaction records to June 30, 2003 to provide at least three-months to bill the lender, from the last property sale within our scope.

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<sup>17</sup> It was necessary to estimate the indemnification agreement date based on the expiration date, agreement term and initial transaction date because the agreement date field wasn't fully populated.

We compared the information in the various systems to determine whether HUD billed lenders for its loss within a reasonable period of time.

We found that HUD did not consistently bill lenders for losses in accordance with active indemnification agreements. HUD billed lenders to recover losses of \$36.8 million from 994 claims, of which HUD has collected or offset other claims for \$20 million and transferred \$1.2 million to HUD's Albany Financial Operations Center. HUD however, has not billed lenders for losses of \$44.4 million resulting from 1,231 claims.

### **Tested Validity of Outstanding Receivables**

We tested the debt collection process by selecting a non-statistical sample of twenty-five delinquent debts for additional review. We found that in four cases the debt was paid, but HUD's system still showed a balance due. Also, in two cases, HUD may not be able to proceed with collection efforts because it could not find the necessary documents to support the debt.

In three cases, HUD's systems showed an outstanding receivable balance because the lender's payments did not include the amount of the final month's accrual of interest. The billing letter does not inform lenders that interest and penalties will accrue if the debt becomes delinquent. Two of the lenders submitted their payments within 45 days of the billing letter and probably did not know that interest was due. The other lender submitted the amount due within 90 days and paid the balance from the last dunning notice and also may not have been aware of additional interest. The *Accounts Receivable Subsystem* only sends dunning notices after the first two months of delinquency.

In one case, the lender paid the debt but the payment had not been fully recorded. When the Claims Branch enters a debt into the *Accounts Receivable Subsystem*, by the indemnified case number, the system automatically uses the originating lender's identification number. Thus, dunning notices will be mailed to the originating lender. HUD usually indemnifies the lender who underwrites the loan, and that can be the sponsor. HUD needs to create a new case in the system, for billing purposes, if the indemnified lender is different than the originating lender. The new case will correctly identify the indemnified lender. The Claims Branch uses the following procedures to provide an audit trail in the system. The Claims Branch sets up the receivable under the original case number; annotates under the original case number that the debt was set up under a new case number; backs out the receivable from the original case number; and sets up the receivable under the new case number.

In this case, the indemnified lender was different than the originating lender and the Claims Branch recorded a debt under the original case number and a debt under the new case number. When the lender submitted the payment, the original case number was credited but the new case number was not. Thus, the system is still showing an outstanding debt. Adjusting entries were made in the *Accounts Receivable Subsystem* to show receipt of funds for cases that we brought to the Claims Branch's attention, where the payments were not credited to the new case number.

## Appendix B

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HUD could not find the documentation for two of the cases in our sample of twenty-five. One case was over a year old and the other was over eleven years old. HUD cannot proceed with collection efforts if it does not have the necessary documents to support the debt.

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# Additional Steps to Facilitate the Active Collection of Debts

Additionally, to facilitate the active collection of debts HUD should:

1. Centralize all collection activities;
2. Add necessary information to the billing letter;
3. Implement a process for resolving disputed indemnification amounts; and
4. Maintain adequate documentation of all collection activity and decisions.

## **Centralize All Collection Activities**

HUD should centralize all collection activities with the Albany Financial Operations Center to the extent possible. Currently debt collections arising from payment plans are done at the four Homeownership Centers and the Enforcement Center. We performed additional tests of the debt collection process by reviewing ten repayment plan requests submitted to the Quality Assurance Divisions at three Homeownership Centers. HUD will approve an installment repayment plan if the lender can show that it would be a hardship to pay the entire balance due. Two Homeownerships Centers approved seven of the ten repayment plan requests. Based on the information provided by the lenders, we agreed with HUD's decision to permit repayment plans with seven lenders. However, we found that:

- The Quality Assurance Divisions had different processes for determining whether the debt payment would cause the lender a hardship.
- Quality Assurance staff did not always review the request in a timely manner. Several repayment plans took over three months to review.
- Two Homeownership Centers did not follow HUD's collection procedures for payments of \$102,000 received from the lenders. The Homeownership Centers did not maintain a log, deposit the checks, endorse the checks, and/or issue sequentially numbered receipts to the lender. Furthermore, transit time is increased and collections are part of the general HUD incoming mail.

HUD has not developed policies or procedures for processing payment plans. The staff at the Quality Control Divisions review and sanction lenders and don't believe they should also be responsible for collecting the debt arising from the sanction. Staff reviewing the payment plans did not always know what constituted a hardship and did not always have the financial background to understand financial documents submitted by the lenders. Furthermore, the Quality Control Divisions were not prepared to receive payments from lenders and had not implemented the appropriate management controls for handling and protecting cash and negotiable instruments.

HUD should implement policies and procedures for processing payment plans and simplify the process by centralizing all collection efforts. If HUD continues to use the Homeownership Centers for collection activity, then it needs to implement the appropriate management controls for handling and protecting cash and negotiable instruments at each Center.

The Claims Branch told us that it initially put the payment plans in the system but found that the system did not properly manage the plans. When the Homeownership Centers process a repayment plan, HUD manually calculates interest and tracks payments outside of HUD's system. This would be eliminated if the Albany Financial Operations Center managed the repayment plan. The *Debt Management Collection System* was designed to process repayment plans, thus payments are calculated and tracked within the system.

### **Add Necessary Information to the Billing Letter**

Adding additional language to the billing letter would facilitate encouraging lenders to promptly pay these debts. Currently, the billing letters contain the basis for the indebtedness, instructions for paying the debt, the date by which payment should be made and a contact person. The billing letters should also contain the following information:

- The rights of the debtor to seek review of the debt by HUD.
- Applicable standards for imposing interest, penalties, and administrative costs.
- HUD's willingness to discuss alternative payment methods.
- HUD's policies with respect to the use of credit bureaus, debt collection centers, and collection agencies.
- Debt collection requirement to transfer debts that are delinquent 180 days or more to Treasury for collection.
- HUD's collection policies and procedures for collecting the debt by offsetting a future claim.
- HUD's remedies to enforce payment of the debt.

We tested the debt collection process for 25 delinquent debts and found that in four cases the debt was paid, but HUD's system still showed a balance due. One case was an oversight and three were due to unpaid interest and penalties. HUD can address the nonpayment of interest and penalties by disclosing in the billing letter that the debt is delinquent after 30 days and interest and penalties will accrue until the debt is paid. HUD may also instruct lenders to call for a payoff amount if the payment will be late. The system used by the Claims Branch only sends dunning notices after the first two months of delinquency. One of the cases above included interest accrued after the last dunning notice was mailed to the lender. If the Albany Financial Operations Center did the initial billing, the lender would receive dunning notices every 30 days until the debt was paid or referred to Treasury.

### **Implement a Process for Resolving Disputed Indemnification Amounts**

The Claims Branch informed us that sometimes lenders dispute the debt because they do not believe HUD maximized efforts to obtain a fair market price on the property sale. Lenders also contend that HUD's discount programs adversely affects the selling price. For example, one lender notified HUD that before it paid the indemnification, it needed a detailed list of items and amounts included in the partial and final settlement, sales expense and sales price. The lender also wanted additional information to understand the \$35,000 discount.

If lenders were immediately notified of the potential indemnification debt when a claim is submitted, it would give more lenders an opportunity to request that HUD convey the property to the indemnified lender and the lender could then sell the property.

The Claims Branch stated that there was not a specific process for resolving disputed indemnification amounts, besides referring the matter to the Homeownership Center who processed the indemnification agreement. The Homeownership Centers have access to the information necessary to resolve a dispute; however, they are also responsible for sanctioning the lender. Consequently, it may be difficult for the lender to get an unbiased opinion.

It would be permissible to delay the accrual of interest for a disputed case for a reasonable period of time. However, the Department would need to establish a system for the quick resolution of the matter. Ideally, the dispute resolution process should be centralized with the other collection activities. The same group of people could control the process. As a result, the dispute resolution policies and procedures would be consistently applied and an unbiased decision could be made within a reasonable period of time.

#### **Maintain Adequate Documentation of All Collection Activity and Decisions**

In two cases, HUD may not be able to proceed with legal collection efforts because it could not find the necessary documents to support the debt. HUD needs to maintain adequate documentation of all collection activity, in a centralized location, for a reasonable period of time after the debt is collected.

HUD also did not have a system for documenting communications with lenders or its basis for making decisions regarding the delinquent debt. HUD also needs to ensure it has a system to document written and verbal communications, and its basis for decisions, regarding the debt.

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# Schedule of Funds To Be Put to Better Use

<u>Recommendation Number</u>	<u>Funds to be Put to Better Use 1/</u>
1A	\$44.4 million
2A	\$15.8 million

1/ Funds to be put to better use include quantifying savings that would be used more effectively if OIG recommendations were implemented.

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# Auditee Comments



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

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

NUV 26 2003

MEMORANDUM FOR: Robert C. Gwin, District Inspector General for Audit, 8AGA

*Maryann Young*  
FROM: John C. Weicher, Assistant Secretary for Housing – Federal Housing  
for Commissioner, H

SUBJECT: Draft Audit Report of Indemnification for Claims on Single Family Insured Loans

In response to your memorandum dated October 28, 2003, requesting the Office of Housing's formal written comments responding to the subject draft report we provide the following information.

**Finding 1 - HUD needs to ensure lenders are consistently billed in a timely manner.**

**Recommendation 1A:** Initiate the billing process to collect \$44.4 million from the 1,231 indemnification cases not billed.

**FHA's Response:** FHA has reviewed the 1,231 cases identified by the IG. The Statement of Accounts (SOAs) for 1,184 of these cases are currently being reconciled to insure that the indemnification request properly accounts for uncollected receivables, sales discounts and any other necessary accounting adjustments. FHA will complete the reconciliation and issue billing statements for the cases that have resulted in an indemnified loss to the Government by March 31, 2004. No indemnification agreement can be located for the remaining 47 cases.

**Recommendation 1B:** Enhance systems to the extent possible to: 1) automate the billing process to bill timely and eliminate the extensive manual research required to bill; and, 2) accurately calculate the current profit and loss on sale amount to eliminate the research needed to properly account for discounts and to reflect the actual status of the loss by reducing the loss after funds have been received.

**FHA's Response:** The Single Family Acquired Asset Management System (SAMS) will be modified to include an automated billing process which will eliminate the need for manually issued billing letters. SAMS will generate a billing letter and a Statement of Accounts Report on a monthly basis for all HUD-owned single family properties covered by an indemnification agreement after the sale of the property has occurred. This modification should be implemented by March 1, 2004 subject to the availability of IT funding.

In the interim, the Statement of Accounts has been revised to display any sales discount separately from the profit and loss and further changes will be made to reflect the actual amount of loss to

FHA upon disposition of the property. These changes will be in place by January 31, 2004 subject to the availability of IT funding.

**Recommendation 1C:** Implement policies and procedures to ensure that discounts are consistently and accurately recorded in HUD systems.

**FHA's Response:** Instructions will be provided to the closing agent contractors by January 31, 2004 to ensure proper and consistent recording of discounts.

**Recommendation 1D:** Locate missing copies of indemnification agreements or remove indemnification flag from the system.

**FHA's Response:** FHA has obtained indemnification agreements for 1,184 of the 1,231 unbilled cases and will issue billing statements as stated in Response 1. The indemnification flag will be removed from the remaining 47 cases.

#### **Finding 2 - Debt Collection Activities Need Improvement.**

**Recommendation 2A:** Formulate and implement policies to ensure that the Department is in compliance with the Debt Collection requirements. Specifically, HUD needs to: 1) Transfer debt delinquent 180 days or more to Treasury, including 431 cases totaling \$15.8 million that were over 180 days delinquent on March 31, 2003; 2) Ensure that interest and penalties are accrued on all eligible debt; and, 3) Properly disclose delinquent debts on the quarterly report to Treasury.

**FHA's Response:** FHA anticipates transferring all activity concerning the billing and collection of indemnification agreements to the Albany Financial Operations Center (FOC) by March 31, 2004. As a part of this transfer, FHA will refer all cases over 180 days delinquent to Treasury by December 31, 2003. Once the function is transferred to the FOC, all receivables will be posted to debt collection systems maintained by Albany which correctly accrue interest and penalties and report delinquencies on quarterly reports to Treasury.

**Recommendation 2B:** Actively pursue collection of delinquent debts by:

1) Imposing administrative sanctions by the Mortgagee Review Board against lenders for breaching indemnification agreements;

**FHA's Response:** The Financial Operations Center will routinely report those institutions that are unresponsive to HUD's demand letters to the Enforcement Center which will refer those institutions to the Mortgagee Review Board for administrative sanctions as appropriate.

2) Centralizing all collection activities with the Albany Recovery Center to the extent possible and maximize the use of all available collection tools;

**FHA's Response:** Plans are being developed to transfer indemnification processing to the Albany Financial Operations Center by March 31, 2004.

2A) If debt collections is not centralized then HUD needs to establish adequate handling and protecting cash and negotiable instrument management controls at the Home Ownership Centers.

**FHA's Response:** Debt collection activity related to the indemnification process is being transferred to the Albany Financial Operations Center as stated above. In addition, by March 1, 2004, the SF HOCs will be directed to instruct mortgagees to send all indemnification collections directly to the Treasury lockbox established to receive these payments.

3) Adding necessary information to billing or demand letters;

**FHA's Response:** Billing and demand letters will be modified to include all necessary debt collection information language by December 31, 2003.

4) Implementing a process for resolving disputed indemnification amounts; establishing procedures to document collection activity, including bases for decisions and maintain documentation for a reasonable period of time.

**FHA's Response:** The Albany Financial Operations Center will implement necessary documentation and retention rules for indemnification processing by June 30, 2004.

**Recommendation 2C:** Research delinquent debts to ensure all debts are valid.

**FHA's Response:** By March 31, 2004, FHA will research all delinquent debt over 180 days old to determine whether the debt is valid and enforceable or should be written off.

#### **Finding 3 - Internal Controls for Processing Indemnification Agreements Can Be Improved**

**Recommendation 3A:** Formulate and implement policies and procedures related to the processing of indemnification agreements used by the Homeownership and Enforcement Centers to ensure and maximize the quality, utility, objectivity and integrity of indemnification information. These policies and procedures should include independent verification of the data entry to ensure that the information is valid; and should address inconsistencies or misunderstandings described in the report concerning agreement dates and the refinance indicator.

**FHA's Response:** By December 31, 2003, FHA will issue policies and procedures to the Homeownership and Enforcement Centers for processing indemnification agreements including handling and protecting cash and negotiable instruments. In addition, by June 30, 2004 the Albany Financial Operations Center will implement controls to verify the accuracy of indemnification information keyed into CHUMS as well as ensure that paper copies of indemnification agreements are received for all indemnified cases.

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# Distribution Outside of HUD

The Honorable Susan M. Collins, Chairman, Committee on Government Affairs

The Honorable Joseph Lieberman, Ranking Member, Committee on Government Affairs

The Honorable Thomas M. Davis, III, Chairman, Committee on Government Reform

The Honorable Henry A. Waxman, Ranking Member, Committee on Government Reform

Elizabeth Meyer, Senior Advisor, Subcommittee on Criminal Justice

Andy Cochran, House Committee on Financial Services

Clinton C. Jones, Senior Counsel, Committee on Financial Services

Kay Gibbs, Committee on Financial Services

Mark Calabria, Committee on Banking, Housing, and Urban Affairs

W. Brent Hall, U.S. General Accounting Office

Steve Redburn, Chief Housing Branch, Office of Management and Budget

Linda Halliday, Department of Veterans Affairs, Office of Inspector General

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