



# *Audit Report*

## **District Inspector General for Audit Southeast/Caribbean District**

*Report: 98-AT-121-0002*

*Issued: May 01, 1998*

**TO:** Art Agnos, Acting Assistant Secretary for Housing-Federal Housing  
Commissioner, H

**FROM:** Nancy H. Cooper  
District Inspector General for Audit-Southeast/Caribbean, 4AGA

**SUBJECT:** Audit of Section 203(k) Rehabilitation Mortgage Insurance Program

We completed an audit of the Section 203(k) Rehabilitation Mortgage Insurance Program as it pertains to owner/occupant borrowers. This report includes two audit findings.

Within 60 days please give us, for each recommendation in this report, 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. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the cooperation and input of the Office of Housing during this audit. Should you or your staff have any questions, please contact me at (404) 331-3369 or Bruce Milligan, Senior Auditor, at (336) 547-4056.

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# Executive Summary

We audited the Section 203(k) Rehabilitation Mortgage Insurance Program as it pertains to owner/occupant borrowers. Our objective was to determine if the 203(k) Rehabilitation Mortgage Insurance Program promotes and facilitates the restoration and preservation of existing housing in an effective, efficient, and economical manner. We reviewed 50 loans made by 40 lenders to 50 owner/occupant borrowers.

The 203(k) Program was generally successful for most of the loans we reviewed. In most cases, the borrowers effectively used most of the loan funds to acquire and substantially improve a property for their residence. Only 1 of the 50 loans tested was in default. Following are two examples of successful loans:



House in Delhi, CA



Kitchen of house in Virginia Beach, VA

Although the program was successful in many respects, our review disclosed that: (1) substantial improvements were needed in lender performance, and (2) borrower information was recorded incorrectly in HUD's database.

#### **IMPROVEMENTS NEEDED IN LENDER PERFORMANCE**

We found 1 or more problems with 40 of the 50 loans we tested. Four loans did not meet eligibility criteria and should not have been approved by the lenders. Some of the rehabilitation work for 19 loans was not complete, and some of the work for 7 loans was done with poor workmanship. The lenders for 28 loans disbursed the rehabilitation escrow funds solely to the borrower without verifying the borrower's actual costs.

These problems increased the Department of Housing and Urban Development's (HUD) risk for the insured loans and reduced the quality of the borrowers' living conditions. HUD needed to take steps to ensure more effective lender performance in loan origination and administration of the rehabilitation process.

#### **BORROWER DATA RECORDED INCORRECTLY IN HUD'S DATABASE**

About one-third of the 82 loans we tested were recorded in HUD's Computerized Homes Underwriting Management System (CHUMS) as loans to owner/occupant borrowers but they were actually made to investors or non-profit borrowers. This high error rate significantly reduced HUD's ability to effectively evaluate the performance of 203(k) loans by borrower type. HUD needs to ensure the information on types of borrowers is correctly recorded in HUD's database.

**RESPONSE TO REPORT**

By memorandum of March 27, 1998, the Acting General Deputy Assistant Secretary for Housing-Federal Housing Commissioner stated that the Housing staff had issued Mortgagee Letter 98-11, Single Family Loan Production - Concerns about 203(k) Underwriting, Loan Processing and Administration, dated February 24, 1998, to address the issues in our draft report (see Appendix C).

The procedures and instructions in Mortgagee Letter 98-11 sufficiently address the problems in the findings except for ineffective work by rehabilitation inspectors. We are recommending that HUD complete issuance of a program change, which the Housing staff has drafted, to require lenders to field review the final inspection report for a sample of the lender's loans.

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HUD	U.S. Department of Housing and Urban Development
CHUMS	Computerized Homes Underwriting Management System

# *Introduction*

## **BACKGROUND**

Section 203(k) loans were authorized by Section 101(c)(1) of the Housing and Community Development Amendments of 1978 (Public Law 95-557) which amended Section 203(k) of the National Housing Act. The program objective is to enable HUD to promote and facilitate the restoration and preservation of the Nation's existing housing stock. The 203(k) Program is regulated in Title 24 of the Code of Federal Regulations, part 203.50 and parts 203.440 through 203.495. Additional requirements are included in the 203(k) Handbook 4240.4 REV-2, *Rehabilitation Home Mortgage Insurance*, and various Mortgage Letters issued by HUD.

From October 1, 1985, through September 30, 1996, HUD endorsed for insurance 40,389 loans under 203(k). In recent years HUD has vigorously promoted the 203(k) Program. The number of loan originations increased significantly from an average of 438 in fiscal years 1986 through 1990, to an average of 3,092 in fiscal years 1991 through 1994, to 8,391 in 1995 and 17,429 in 1996. Based on the number of originations for the first 9 months of fiscal year 1997, the number of projected loans for the completed year is 20,664. The claim/default rate for all 203(k) loans originated in the 8 year period ended December 31, 1995, was 6.5 percent for all types of borrowers. The rate for loans to owner/occupant borrowers was 5.4 percent.<sup>1</sup> In comparison, the claim/default rate for 203(k) investor and non-profit borrower loans was 10.7 percent.

The Section 203(k) Program is administered by the Office of Insured Single Family Housing within HUD's Office of Housing.

The Secretary's Performance Report for fiscal year 1996 included a management plan for the Section 203(k) Program. The plan provided that the Secretary's priority was to make home ownership a reality for more Americans and that the commitment was to expand home ownership opportunities for more Americans. The plan included the goal of endorsing 7,506 Section 203(k) loans. HUD exceeded the goal by endorsing 17,429 Section 203(k) loans. The fiscal year 1997 management plan included a goal to endorse 16,232 Section 203(k) loans. HUD again exceeded the goal by endorsing 19,058 Section 203(k) loans. HUD has also prepared a draft strategic plan for fiscal years 1999 through 2003 which includes an overall goal to help create new affordable housing and home ownership opportunities for Americans. The strategic plan includes a draft performance measure for Section 203(k) loans, but no specific goals have been established.

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<sup>1</sup> The 5.4 percent rate is based on information in HUD's database. However, as discussed in Finding 2, the default rate for owner/occupant borrowers is probably significantly lower than 5.4 percent.

**AUDIT OBJECTIVES, SCOPE AND METHODOLOGY**

Our objective was to determine if the Section 203(k) Rehabilitation Mortgage Insurance Program promotes and facilitates the restoration and preservation of existing housing in an effective, efficient, and economical manner. Our review included only loans to owner/occupant borrowers.

The 50 loans we reviewed are listed in Appendix A. The loans were endorsed by HUD for insurance from January 1 through June 30, 1996. Our final sample included 10 loans selected randomly for each of the five districts which had the largest volume of 203(k) loans. We selected the sample from HUD's single family loan database which designated which loans were to owner/occupant borrowers. We determined that some of the initial loans selected were made to investors and non-profit borrowers instead of owner/occupants. To obtain our final sample of 50 loans, we verified the borrower type for 82 randomly selected loans included in HUD's database as owner/occupant loans.

For each loan, we interviewed lender staff to determine the lender's administrative controls over the program. We reviewed the loan origination file. On a test basis, we examined the closing agent's records and verified the receipt and disbursement of the funds at loan closing. In some cases we verified loan data with the borrower. We reviewed a test of the lender's rehabilitation escrow disbursements for supporting documentation. We inspected the exterior of all 50 properties and the interior of 45 properties. We were not able to obtain access to the interior of five properties.

Our audit generally covered the period December 1, 1995, through March 31, 1997. We performed the audit February through July 1997. The audit was conducted in accordance with generally accepted government auditing standards.

# *Findings*

## **Finding 1**

### **Improvements Needed in Lender Performance**

For most of the 50 loans we reviewed, the borrowers effectively used most of the loan funds to acquire and substantially improve a property for their residence. However, there were 1 or more problems with 40 of the 50 loans as follows:

- Four loans did not meet eligibility criteria and should not have been approved by the lenders.
- Some of the rehabilitation work for 19 loans was not complete, and some of the work for 7 loans was done with poor workmanship.
- The lenders for 28 loans disbursed the rehabilitation escrow funds solely to the borrower without verifying the borrower's actual costs.

These problems increased HUD's risk for the insured loans and reduced the quality of the borrowers' living conditions. HUD needed to take steps to ensure more effective lender performance in loan origination and administration of the rehabilitation process.

#### **CRITERIA**

HUD's requirements for lender origination of 203(k) Program loans are included in the 203(k) Handbook 4240.4 REV-2, Rehabilitation Home Mortgage Insurance, and various Mortgage Letters issued by HUD.

#### **INELIGIBLE LOANS**

Four of the 50 test loans were ineligible for the following reasons:

A lender approved one loan as a refinance, but the loan was ineligible because the borrower did not have a debt secured by a lien on the property. The lender knew there was no lien on the property and should not have approved the loan.

The lender should not have approved the same loan also because the lender had substantial evidence that the borrowers would not use the property as their principal residence. Both borrowers were employed about 125 miles from the 203(k) property and maintained a residence in the area of their employment when they applied for the loan.

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By its design and location, the 203(k) property was primarily suitable as a vacation property. After receiving the loan, the borrowers did not occupy the 203(k) property as their principal residence.

Lenders approved three loans when the rehabilitation work did not meet HUD's requirement that the work include at least \$5,000 of eligible improvements. In all three cases, the work write-ups included large amounts for interior and/or exterior painting. HUD's procedures allow the cost of interior and exterior painting not necessitated by other repairs to be included in the loan, but not in the amount used to meet the \$5,000 requirement. The work write-ups for two loans clearly showed the \$5,000 requirement was not met, so the lenders should not have approved the loans. The work write-up for the third loan included \$5,000 of eligible repairs when the lender approved the loan. However, the lender allowed the borrower to use \$2,621 of the rehabilitation funds to pay down the loan instead of completing repairs included in the work write-up. As a result, the borrower completed only \$3,155 of repairs needed to meet the \$5,000 requirement.

### **INCOMPLETE AND SHODDY REPAIRS**

The rehabilitation work was not fully completed for 19 loans and some of the work for 7 loans was done with poor workmanship.

The rehabilitation work for eight loans was still in process but the work was far behind schedule. HUD's procedures require the work to be completed within 6 months, or a shorter period set by the lender when the work is not complicated. The lender may approve an extension of 6 months if warranted. For seven of the eight loans, more than 12 months had passed since loan closing. More than 10 months had passed for the other loan. In seven of the eight cases, the borrowers were performing some or all of the work themselves. It appeared that they did not have either the time or the expertise to timely complete the rehabilitation work. Some of the borrowers said they did not understand that they were supposed to complete the work within 6 months. In at least two cases where the borrower acted as the contractor, the lender did not require the borrower to execute a self-help agreement as required.



Work behind schedule, Rensselaer, NY

The lenders closed out 11 loans although some of the rehabilitation work was not completed. The estimated cost of the uncompleted work was under \$500 for four properties and from \$500 to \$2,000 for the other seven properties. Examples included doors and a kitchen countertop which were not installed, a sink and a leaking toilet seal which were not replaced, and interior and exterior painting which was not performed.



Unpainted new window, Louisville, KY

Some of the work for seven houses was also performed with poor workmanship. Examples included two roofs which were repaired but still leaked, windows which were painted shut, siding which came loose after installation, and a bathtub surround which did not fit.



Bathtub surround improperly installed, Avenal, CA

The incomplete and poorly performed rehabilitation work reduced the quality of the living conditions for the borrowers and reduced the value of their property.

### **INADEQUATE CONTROL OVER PAYMENTS**

For 28 loans, the lenders disbursed part or all of the rehabilitation funds solely to the borrower. In some cases, the borrower used a contractor, but the lender did not include the contractor as a co-payee on the check. In other cases, the borrower performed some or all of the work and the lender did not obtain evidence of the borrower's actual costs. In four cases, the borrower was able to furnish documentation to support cost for all of the rehabilitation funds the borrower received. For 8 of the remaining 24 cases, the borrower apparently retained part of the rehabilitation funds as sweat equity for the work the borrower performed.

By making the payments solely to the borrower without obtaining evidence of the borrower's costs, the lenders did not maintain effective control over the rehabilitation funds. The procedure increased the chance of payments for: (1) work not performed, and (2) borrower sweat equity which is not permitted by the 203(k) Program.

Better controls were practical because the lenders for the other 22 loans either made the rehabilitation payments jointly to the borrower and the contractor or required the borrower to furnish evidence of the borrower's costs.

### **INCREASED RISK OF LOSS TO HUD**

Approval of ineligible loans, failure to timely and properly complete the rehabilitation work, and inadequate controls over the payment of rehabilitation funds increased the risk of loan defaults and losses to HUD.

### **IMPROVEMENTS NEEDED IN LENDER PERFORMANCE**

The lenders needed to improve program performance.

For all four of the ineligible loans, the lenders had sufficient information to make the correct determination that the borrowers were not eligible. The lenders apparently ignored or misinterpreted the information.

The lenders needed to make several improvements to prevent the cases where the borrowers did not complete the rehabilitation work on time. In those cases where the borrower proposes to act as the contractor, the lenders should determine whether the borrower has the expertise and the time to complete the work. If the lender approves the borrower as the contractor, they should require the borrower to sign a self-help agreement. The lenders need to ensure the borrowers fully understand the time limitation for the work. Where adequate progress is not made and where warranted, the lenders need to make use of the lender's available remedies of declaring the loan in default and using remaining funds to complete the work or pay down the loan.

The payments for incomplete work for closed out loans and the cases of shoddy work were all supported by inspection reports certifying that the work was properly completed. The inspectors did not perform effectively in these cases. The lenders needed to perform tests of the inspectors' work. HUD has drafted a program change to require lenders to field review the final inspection report for 10 percent of the lender's loans.

The lenders who made payments solely to the borrowers without obtaining documentation of the borrowers' costs did not properly control the rehabilitation funds. In these cases, the lenders relied on the work write-ups for the cost amounts. However, this procedure was ineffective because it did not prevent overpayments to the borrower in cases where the borrower: (1) performed part of the rehabilitation work, or (2) was able to obtain work or materials cheaper than the cost estimate.

**RESPONSE TO FINDING**

By memorandum on March 27, 1998, the Acting General Deputy Assistant Secretary for Housing-Federal Housing Commissioner stated that the Housing staff had issued Mortgagee Letter 98-11, Single Family Loan Production - Concerns about 203(k) Underwriting, Loan Processing and Administration, dated February 24, 1998, to address the issues in our draft report (see Appendix C).

Mortgagee Letter 98-11:

- Reminds lenders of their responsibility to ensure that the borrowers meet loan eligibility requirements and, if it is determined that loan eligibility requirements were not met, that HUD may require indemnity and/or report abuses to the Office of Lender Activities and Program Compliance for review and to the Mortgagee Review Board.
- Instructs lenders to: (1) play a more active role in assuring the rehabilitation work is completed on schedule, (2) require borrowers to execute complete contracts with contractors, and (3) make sure that borrowers who elect to do their own work have the time and expertise to complete the work on schedule and complete a self-help agreement.
- Requires lenders to improve controls over payments of rehabilitation funds by: (1) making payments jointly payable to the borrower and contractor, or (2) in cases where no contractor is used, obtaining documentation of the borrower's actual costs.

**EVALUATION OF RESPONSE**

The procedures and instructions in Mortgagee Letter 98-11 sufficiently address the problems in the finding except for ineffective work by rehabilitation inspectors. Our draft report noted that HUD had drafted a program change to require lenders to field review the final inspection report for a sample of the lender's loans. This change, although still in process, has not been issued.

**RECOMMENDATION**

- 1A. We recommend that the Office of Housing issue the proposed change to require each lender to field review the final inspection report for a sample of the lender's loans to ensure the quality of the inspectors' work.

## **Finding 2**

### **Borrower Data Recorded Incorrectly in HUD's Database**

About one-third or 28 of the 82 loans we tested were recorded in HUD's CHUMS as loans to owner/occupant borrowers, but they were actually made to investors or non-profit borrowers. This high error rate significantly reduced HUD's ability to effectively evaluate the performance of 203(k) loans by borrower type. HUD needs to ensure the borrower type data is correctly recorded in HUD's database.

#### **CRITERIA**

HUD requirements for insurance endorsement and related data entry are included in Handbook 4165.1 REV-1, Endorsement for Insurance for Home Mortgage Programs, Chapter 2. HUD's specific procedures for data entry for 203(k) loans are included in the CHUMS User Handbook and the CHUMS Terminal Operations Guide. For lender entry of the data, the lenders have a manual for the CHUMS Lender Access System.

#### **LOANS WERE INCORRECTLY RECORDED**

We randomly selected 82 loans entered in HUD's CHUMS system as being made to owner/occupant borrowers. We verified whether the loans were to owner/occupants, and found that 28 were actually to either investors or non-profit borrowers. In our previous audit of investor and non-profit loans, we found no loans recorded as investor and non-profit loans which were actually made to owner/occupants.

HUD's database indicates that about 80 percent of 203(k) loans have been made to owner/occupants and only about 20 percent have been made to investors and non-profit borrowers. However, our sample results indicate that the actual portion of owner/occupant loans is only about 50 percent and the portion of investor and non-profit loans is significantly higher, also about 50 percent.

#### **ADVERSE EFFECTS ON MONITORING AND PROGRAM EVALUATION**

The incorrect recording of the borrower type in HUD's database adversely affects HUD's monitoring and evaluation of the 203(k) Program results. As an example, HUD's database indicates that the claim/default rate for owner/occupant loans originated through 1995 is about 5.4 percent while the rate for investors and non-profits is about 10.7 percent. However, because of the incorrect data for the type of borrower, the claim/default rate for owner/occupants is probably significantly lower than 5.4 percent.

The incorrect borrower data results from the data being recorded incorrectly in HUD's CHUMS system. There is a choice of five codes for the borrower type: occupant, landlord, escrow commitment, corporation, and government/non-profit. The first code, occupant, should never be appropriate for investors and non-profit loans. For about one-third of the owner/occupant loans in our sample, the data entry person incorrectly chose the occupant code. The persons performing the data entry apparently did not verify the borrower type from appropriate documents such as the Loan Application and the 203(k) Maximum Mortgage Worksheet. However, we also noted cases where the purpose of the loan and the borrower type were either not recorded or incorrectly recorded on these documents.

In the past, data entry was performed by HUD staff for some loans and by the lenders for other loans. In the future, the lenders will perform all of the data entry work.

### **RESPONSE TO FINDING**

By memorandum on March 27, 1998, the Acting General Deputy Assistant Secretary for Housing-Federal Housing Commissioner stated that the Housing staff had issued Mortgagee Letter 98-11, Single Family Loan Production - Concerns about 203(k) Underwriting, Loan Processing and Administration, dated February 24, 1998, to address the issues in our draft report (see Appendix C).

Mortgagee Letter 98-11 clarifies the types of loans which should be entered as owner/occupant loans in the CHUMS system and directs the lenders to improve the accuracy of their data entry work.

### **EVALUATION OF RESPONSE**

The Housing staff's response adequately addresses the problem. We are making no recommendation and consider the finding as resolved.

# *Follow-up on Prior Audits*

On February 6, 1997, we issued a report, Audit of Section 203(k) Rehabilitation Mortgage Insurance Program, to the Assistant Secretary for Housing-Federal Housing Commissioner. The report included two findings relating to needed improvements for loans to investors and non-profit borrowers. The recommendation for one finding was resolved. Nine of the ten recommendations for the other finding are resolved or have management decisions. A resolution of our disagreement for recommendation 1A still rests with the Deputy Secretary.

On August 27, 1997, we issued an audit-related memorandum on HUD's procedures for approving consultants and consultant trainees for the Section 203(k) Program. Its two recommendations have management decisions awaiting final action.

**Appendix A****Schedule of Loans Reviewed**

<u>District</u>	<u>Loan Number</u>	<u>Location</u>	<u>Status</u>	<u>Amount</u>
New York/New Jersey				
	351-3041723	Southampton, NJ	Current	\$ 60,700
	351-3088490	Bellmawr, NJ	Current	107,600
	351-3100640	Hainesport, NJ	Current	111,100
	352-3087559	Ocean Grove, NJ	Current	127,650
	352-3062120	East Orange, NJ	Current	82,850
	371-2317582	Rensselaer, NY	Current	53,900
	371-2332182	Margaretville, NY	Current	61,550
	372-2561557	Elmira, NY	Current	48,500
	374-2165755	Brooklyn, NY	Current	169,000
	374-2204711	New Rochelle, NY	Current	150,150
Mid-Atlantic				
	241-4242364	Baltimore, MD	Current	\$ 99,450
	241-4346531	Baltimore, MD	Current	69,650
	241-4357222	Baltimore, MD	Paid off	131,900
	241-4361805	Hanover, MD	Current	132,500
	241-4382370	Baltimore, MD	Current	92,950
	249-3084463	Berwyn Heights, MD	Current	130,200
	441-5100597	Wellsboro, PA	Current	77,150
	441-5139546	Philadelphia, PA	Current	74,000
	541-4648803	Virginia Beach, VA	Current	85,000
	548-2929491	Woodbridge, VA	Current	132,150

<u>District</u>	<u>Loan Number</u>	<u>Location</u>	<u>Status</u>	<u>Amount</u>
Southeast/Caribbean				
	101-7454723	Atlanta, GA	Current	\$ 90,600
	461-3204072	Irmo, SC	Current	80,100
	501-4960247	Bayamon, PR	Current	62,100
	482-2885925	Memphis, TN	Default	50,600
	011-4093124	Bessemer, AL	Current	55,800
	091-2842462	Gainesville, FL	Current	74,950
	093-4046017	Bradenton, FL	Paid off	87,200
	094-3374297	Apopka, FL	Current	78,400
	094-3389335	Sanford, FL	Current	34,450
	201-2472558	Louisville, KY	Current	75,950
Midwest				
	412-3772786	Maple Heights, OH	Delinquent	\$ 63,800
	412-3786329	Cleveland, OH	Current	39,050
	131-8272433	Chicago, IL	Current	152,300
	131-8266118	Island Lake, IL	Current	71,900
	151-4896682	Darlington, IN	Delinquent	77,150
	151-4912631	Indianapolis, IN	Current	63,850
	151-5004908	Elwood, IN	Current	85,900
	261-6432448	Dearborn Heights, MI	Current	81,950
	271-7420593	Brooklyn Center, MN	Current	103,050
	413-2959652	Hebron, OH	Delinquent	71,950
Pacific/Hawaii				
	021-8761037	Mesa, AZ	Current	\$107,800
	021-8774292	Phoenix, AZ	Current	50,550
	041-9013810	Compton, CA	Current	103,950
	041-9063977	Pico Rivera, CA	Current	137,050
	041-9017733	Lakeview Terrace, CA	Current	90,900
	041-9092553	Canoga Park, CA	Current	120,600
	044-3369985	Chula Vista, CA	Current	90,176
	045-4258441	Avenal, CA	Current	44,600
	045-4325523	Delhi, CA	Current	85,600
	043-5523865	Loomis, CA	Paid off	149,000

## Appendix B

### Summary of 203(k) Program Procedures

Following is a summary of how the 203(k) Program works.

The program can be used to rehabilitate dwellings in one of three ways: (1) purchase a dwelling and the land on which the dwelling is located, (2) purchase a dwelling on another site and move it onto a foundation on the mortgaged property, and (3) refinance existing indebtedness. Eligible properties include one to four family dwellings that have been completed for at least 1 year and homes that have been demolished or need to be razed if the existing foundation system is not affected and will be used. A one family dwelling can be converted to a two to four family dwelling or a multi-unit dwelling can be decreased to a one to four family unit; and a property that is used for residential and commercial purposes may be eligible under certain circumstances.

The potential borrower locates an eligible property. The borrower submits an application to a lender and enters into a sales contract that is contingent upon 203(k) loan approval and the borrower's acceptance of any additional required improvements as determined by HUD or the lender.

Either the borrower or a consultant prepares a work write-up and cost estimate. The rehabilitation must include at least \$5,000 of eligible improvements on the existing structure on the property. Any repair is acceptable in the first \$5,000 requirement that may affect the health and safety of the occupants. Minor or cosmetic repairs by themselves cannot be included in the first \$5,000, but may be added after the \$5,000 threshold is reached. Following the lender's acceptance of the work write-up and cost estimate, the lender requests assignment of a HUD case number. A plan reviewer meets with the borrower and contractor at the property to ensure that the work write-up and cost estimate are acceptable and all program requirements are met. A written appraisal is prepared of the expected property market value after rehabilitation work is completed. In some cases, an as-is appraisal is also required.

The lender reviews the application and the appraisal to determine the maximum insurable mortgage amount for the property. The mortgage amount is limited to the loan-to-value ratio and maximum dollar amount that apply to similar properties under Section 203(b). The value of the maximum mortgage calculation is based on the lesser of : (1) as-is value of property plus rehabilitation costs, or (2) 110 percent of the expected property market value after rehabilitation work is completed. The as-is value of the property is usually based on the borrower's purchase price, or for refinance cases, an as-is appraisal. The rehabilitation cost can include up to six mortgage payments to assist the borrower when the property is not occupied during rehabilitation. The maximum mortgage

amount for owner occupants and non-profit borrowers is based on 97/95/90 percent of the maximum mortgage calculation. The maximum mortgage amount is based on 85 percent of the maximum mortgage calculation if the property is purchased for investment purposes. The lender completes a review of the borrower's credit and ability to repay the loan.

The 203(k) loan is then closed and the lender submits copies of the mortgage documents to HUD for review. If documents are found acceptable, HUD issues a Mortgage Insurance Certificate to the lender.

The borrower then has up to 6 months to complete the rehabilitation work. As the rehabilitation work progresses, funds are released from the rehabilitation escrow account after the work is inspected by a HUD approved inspector. Any unused funds in the rehabilitation escrow account are applied to the mortgage.

## Appendix C

## Auditee Comments

 U. S. Department of Housing and Urban Development  
Washington, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY  
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MAR 27 1998

MEMORANDUM FOR: Nancy H. Cooper, District Inspector General  
for Audit, Southeast/Caribbean, 4AGA

FROM:  ACT Aggers, Acting General Deputy Assistant Secretary  
for Housing-Federal Housing Commissioner, H

SUBJECT: Draft Audit 98-AT-101-000X on 203(k)  
Owner Occupant Mortgages

This is to confirm conversations between our staff that we have issued Mortgagee Letter 98-11, Single Family Loan Production - Concerns about 203(k) Underwriting, Loan Processing and Administration (Mortgagee Letter), to address the issues raised in Draft Audit 98-AT-101-000X on 203(k) Owner Occupant Mortgages. We understand that Bruce Milligan of your staff reviewed this Mortgagee Letter during its Departmental Clearance and that his comments were incorporated. As identified in your audit, this letter reminds lenders of their need to comply with all underwriting requirements for the program, strengthened the controls over construction contractors, and ensure the accuracy of all data they enter into the CHUMS system. For your perusal, I have attached Mortgagee Letter 98-11.

I appreciate your willingness to work with us on this matter. If you have questions, please contact Vance Morris of my staff at (202) 708-2700, ext. 2204.

Attachment



U. S. Department of Housing and Urban Development  
Washington, D.C. 20410-8000  
February 29, 1998

OFFICE OF THE ASSISTANT SECRETARY  
FOR HOUSING FEDERAL HOUSING COMMISSIONER

MORTGAGE LETTER 98-11

TO: ALL APPROVED MORTGAGEES

SUBJECT: Single Family Loan Production - Concerns about 203(k) Underwriting, Loan Processing and Administration

The purpose of this Mortgage Letter is to emphasize the Department's concerns that Direct Endorsement lenders strictly observe the underwriting guidelines of HUD Handbooks 4155.1 REV-1 and 4240.4 REV-2, exercise care in assuring the accuracy of 203(k) loan data entered in the CHUMS system, and conduct more active oversight of construction progress and contractor performance.

HUD's Office of Inspector General recently audited a random sample of 203(k) loans made to owner-occupied borrowers nationwide. While generally favorable, the draft audit report cited a number of problems which continue to raise Departmental concerns about the insurance risks of home improvement loans. The problems included questionable loan origination decisions, excessive data entry errors in coding the loans in the CHUMS system, and less than effective administration of the rehabilitation process. To help mitigate these concerns, lenders must assure their staff underwriters are properly trained in using the 203(k) program and strictly follow FHA guidelines. Lenders should also take specific steps to improve quality control over data entry and comply with the loan administration directives of the Mortgage Letter.

**1. 203(k) Loan Underwriting.**

Lenders must strictly observe FHA underwriting guidelines when approving 203(k) loan applications. Underwriting decisions questioned by the Inspector General included approving loans for home improvements on a vacation property and for work items that did not meet the \$5,020 minimum threshold for loan eligibility. Lenders are reminded that, when underwriting 203(k) loans, the compliance tests for loan enforcement must be met. The Department may require indemnity in egregious cases and/or report abuses to the Office of Lender Activities and Program Compliance for review and to the Mortgage Review Board (See Mortgage Letter 97-45).

**2. Data Entry in CHUMS.**

Lenders must improve the accuracy of loan data entered in the CHUMS system. The Inspector General tested 82 randomly selected 203(k) loans closed in FY 1998 and coded as owner-occupied borrowers. Twenty-eight of the loans (34%) were actually made to investors or non-profits, as evidenced in the loan documents. Error rates of this magnitude significantly reduce the Department's ability to effectively monitor or accurately report portfolio performance. Lenders should have quality controls in place to assure data entry is done properly. Data codes are available in CHUMS to describe "borrower type." The first code, occupant, should never be appropriate for investor or non-profit borrowers. Departmental staff will monitor CHUMS input for compliance.



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A. 203(K) Loan Administration

Lenders need to play a more active role in assuring construction work progresses on schedule and workmanship is acceptable. The Inspector General noted that lenders released loan proceeds to pay contractors when some of the rehabilitation work was incomplete or not done to standards. While concerns about timely and quality construction work are not new to home improvement contracts, the Department believes lenders can be a more effective control over contractor performance. Lenders should not close 203(K) loans before approving an acceptable general contractor when borrowers want the work done on contract. Lenders are also encouraged to intervene early in disagreements between borrowers and contractors. Complaints to the Department suggest that misunderstandings of work scope and the absence of written agreements to changes often contributed to subsequent disputes and construction delays. Therefore, it is imperative that borrowers and contractors complete a Homeowner/Contractor Agreement (see Mortgage Letter 94-11, Attachment 2). The Agreement must include a provision for binding arbitration when construction disputes cannot be resolved through lender intervention.

Lenders should make sure borrowers who elect to do their own work, have the time and expertise to complete the rehabilitation work on schedule. The Inspector General found that borrowers often did not complete the work within the lender's or the Department's required time constraints. Borrowers desire their own work must have lender approval, sign a self-help agreement, and fully understand that construction must be completed within six months of loan closing or a shorter period, as determined by the lender.

Lenders also need to improve control over fund disbursements. The Inspector General found checks issued solely to the borrower, not the contractor as co-payee, when the contractor requested payment. Lenders also issued checks to borrowers, who were approved to do the construction themselves, without documented receipts of actual costs. Borrowers are not eligible for reimbursement of "sweat equity" under 203(K) guidelines, as discussed in Mortgage Letter 94-11 and stated in the borrower's Self-Help Agreement. Therefore, lenders should instruct borrowers that, as general contractors, they must maintain complete records showing the actual cost of rehabilitation. Documentation of actual costs means paid receipts and lien waivers from subcontractors. The lender should review the adequacy of the borrower's records through periodic requests for documentation of money spent on materials under the project to a whole.

If you have any questions concerning the content of this Mortgage Letter, please contact your local HUD Office. If you are aware of any fraud in HUD programs, report the matter by calling your nearest HUD Office or the HUD Regional Inspector General. You may also call the HUD Hotline at 1-800-547-3733 or 202-708-2451.

Sincerely,

*Nicholas P. Rostone*

Nicholas P. Rostone  
Assistant Secretary for Housing-  
Federal Housing Commissioner

## Appendix D

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