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Report to the Secretary of Housing and
Urban Development

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February 1991

FEDERAL HOUSING ADMINISTRATION

Monitoring of Single Family Mortgages Needs Improvement

93-23458



4188

Resources, Community, and
Economic Development Division

B-240667

February 7, 1991

The Honorable Jack F. Kemp
The Secretary of Housing and Urban Development

Dear Mr. Secretary:

Within the Department of Housing and Urban Development (HUD), the Federal Housing Administration (FHA) administers the Section 203(b) insurance program for single family homes. The Section 203(b) program provides mortgage insurance to lenders to encourage them to make loans to first-time homebuyers and others who might not qualify for conventional loans. This program accounts for substantially all of the insurance activity of FHA's largest fund, the Mutual Mortgage Insurance (MMI) Fund, with insurance-in-force totaling \$305 billion on September 30, 1990. The MMI Fund incurred losses of \$1.4 billion in fiscal year 1988. This occurred largely because of a \$1.2-billion increase in the Fund's loss reserves to cover anticipated costs of a large number of foreclosures on insured loans. Price Waterhouse is currently conducting a financial audit of FHA for fiscal year 1989 and expects to complete the work in January 1991.

The Comptroller General's Standards for Internal Control in the Federal Government, along with the Federal Managers' Financial Integrity Act of 1982 (FMFIA), emphasizes the need for an agency's internal controls to provide reasonable protection from fraud, waste, and mismanagement. Our concern about the fiscal year 1988 loss and a long-standing need to improve FHA's internal controls (see Related GAO Products, p. 50) led us to review FHA's current process for monitoring the program. To facilitate our review, we limited it to FHA headquarters and to FHA field offices in Los Angeles, California, and Tampa, Florida, and their respective regional offices. FHA indicated that these offices would constitute a fair basis for assessing field offices' monitoring performance. Our review focused on fiscal year 1988, the last year for which complete data were available during our review. Specifically, we examined how these offices

- monitored the applications from and the performance of program participants, such as lenders and appraisers, and addressed deficiencies found during the assessment and
- documented the monitoring process and performed any corrective actions.

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Results in Brief

FHA could not readily provide us with either a comprehensive description of how it monitors the Section 203(b) insurance program or a list of its monitoring activities. However, through a review of agency materials and discussions with FHA officials, we identified 25 (2 headquarters and 23 field office) monitoring activities, or "procedures," which contained monitoring and corrective actions.¹ FHA uses the procedures in its review of the mortgage credit, valuation, and loan management areas of the Section 203(b) insurance program.

In fiscal year 1988, Los Angeles did not fully comply with 9 of its 22 applicable monitoring action requirements and 5 of 15 applicable corrective action requirements;² Tampa did not fully comply with 8 of the 22 applicable monitoring action requirements and 8 of the 16 applicable corrective action requirements. In addition, we could not determine compliance with 4 monitoring action requirements and up to 10 corrective action requirements in Los Angeles and Tampa because either they had not been documented or FHA's guidance was not sufficiently specific to determine when corrective actions should have been taken. (See app. III.) This lack of documentation runs counter to FMFIA's guidance and the Comptroller General's internal control standards.

We determined compliance with the 9 remaining monitoring action requirements (but no applicable corrective actions) in Los Angeles and 10 monitoring and 3 corrective actions in Tampa. FHA headquarters complied with the two applicable procedures that we reviewed.

According to FHA officials in the Los Angeles and Tampa field offices, these offices did not always follow or document procedures used to monitor the program. Some of the reasons given included (1) placing other duties in higher priority, (2) not knowing that the monitoring or corrective actions were required, and (3) not being required by FHA to provide documentation. During field office briefings, the officials indicated that they would correct most of the identified problems.

¹ Each procedure contains a monitoring action. Some procedures also contain one or more corrective actions.

² We did not analyze compliance with the monitoring action requirements in one field office procedure because the offices had no activity warranting that procedure in fiscal year 1988.

We could not analyze compliance with 4 of 20 corrective action requirements at Tampa and 5 of the 20 corrective actions at Los Angeles because they were not applicable to the individual field offices for various reasons, including these: (1) procedures had not been performed for which the actions were to be taken and (2) procedures had been performed concurrently so separate actions were not required.

Background

Until 1983, FHA performed most of the loan underwriting for lenders. Underwriting usually includes determining the borrower's ability to repay the loan and performing appraisals, which establish the value of the property to be mortgaged. FHA also made the insurance commitment for lenders. In 1983, the agency implemented the Direct Endorsement Program, which authorized approved lenders to underwrite loans without FHA's prior approval. Currently, over 90 percent of all FHA-insured loans are processed by direct endorsement lenders.

FHA-approved lenders are responsible for "servicing" FHA-insured mortgages. Servicing activities range from educating borrowers about their rights and responsibilities under a mortgage to referring delinquent or defaulting borrowers to an FHA-approved housing counseling agency³ and foreclosing on insured property when necessary.

An effective monitoring system, or system of internal controls, is critical to FHA's ability to safeguard the MMI Fund against undue risk and to ensure that the Section 203(b) program complies with statutory, regulatory, and administrative requirements. To be fully effective, the system must ensure that corrective action is taken when monitoring discloses unsatisfactory performance or conditions. Essentially, the monitoring system needs to provide reasonable assurance that (1) insured loans do not exceed established limits, (2) property values have been correctly established, (3) borrowers have the ability to repay, (4) loans are properly serviced to minimize defaults and their attendant losses, and (5) foreclosed properties are protected and their disposal properly managed to avoid unnecessary losses.

FHA's current monitoring operation has two primary components, the first of which involves direct reviews of individual loans or appraisals. FHA monitors three main areas of the Section 203(b) program: (1) mortgage credit, which includes lender approval and underwriting activity review; (2) valuation, which includes appraiser and appraisal monitoring; and (3) loan management, which includes mortgage-servicing review.⁴ The second component involves visits to lenders, or on-site

³A public or private entity approved by HUD to provide housing counseling and advice to existing and potential housing consumers on, among other things, how to avoid mortgage default and foreclosures.

⁴A fourth area of the program, property disposition, is the subject of an ongoing GAO review and not included here.

reviews of loan origination and servicing practices. Although an important aspect of the monitoring operation, FHA's on-site reviews are not a subject of this report.

In FHA's three-tiered hierarchy—headquarters, regional offices, and field offices—the field offices, responsible for 23 of the 25 reviewed monitoring procedures, perform the bulk of the monitoring activity. FHA's Performance Evaluation System stipulates that regional offices are to assess the management and quality of field office activities, as well as field office compliance with established policy and procedures. We did not include this regional office assessment in our review.

The Procedures

In producing a comprehensive description of the Section 203(b) monitoring operation, we initially identified and reviewed 25 procedures, or internal control techniques, by examining many of FHA's policies, procedures, and guidance and through discussions with FHA officials. FHA officials reviewed these 25 procedures, and we revised them in accordance with their review to ensure their completeness and accuracy. FHA headquarters and field offices are to use these procedures in their reviews of the mortgage credit, valuation, and loan management areas of the Section 203(b) program. (See app. I for a more detailed description of our methodology and app. II for a list of the procedures identified.)

FHA headquarters staff are responsible for performing two of the procedures included in our review. These two, which address mortgage credit issues, determine if lenders desiring to participate in the program meet FHA's experience, net worth, and credit requirements and, once admitted to the program, if they continue to comply with these and FHA's other requirements.

FHA field offices, whose activities are under FHA's regional office oversight, have responsibility for the remaining 23 reviewed procedures. These procedures address mortgage credit, valuation, and loan management issues by ensuring that (1) lenders, appraisers, and housing counseling agencies are qualified; (2) underwriting, appraising, and counseling activities are performed in accordance with FHA's requirements, and (3) FHA staff are correctly processing and servicing loans. For example, procedure no. 18, pertaining to valuation, requires field offices to review 10 percent of all appraisals and 5 percent of each appraiser's appraisals to determine whether they have been properly performed.

When FHA's monitoring reveals deficient performance by lenders or appraisers, 7 of the 25 procedures we reviewed require various actions to correct and/or improve performance. For example, when FHA's monitoring identifies deficient underwriting by direct endorsement lenders, the lenders may be required to take additional training or be placed on pre-closing review status, which requires that the field office review 15 test cases (loan packages). Once the lender has submitted 15 satisfactory test cases, its direct endorsement status is reinstated.

Extensive Noncompliance With Requirements for Monitoring and Corrective Actions

In fiscal year 1988, FHA headquarters complied with the two procedures reviewed by GAO.⁵ However, the FHA Tampa and Los Angeles field offices did not comply with 8 and 9 procedures, respectively, of 22 applicable ones containing up to 16 applicable corrective actions.⁶

Certain of the procedures' monitoring actions were either not implemented or were implemented incorrectly or in an untimely fashion. Because four applicable monitoring actions had been documented inadequately, we could not determine if the field offices had complied with requirements for these actions. In addition, a number of corrective actions were not performed. We also could not determine compliance with up to 10 of the field offices' applicable corrective action requirements because of nonexistent documentation or FHA's unclear criteria. (See app. III.)

Monitoring Actions Not Performed or Performed Inadequately

Although Tampa complied with 10 of 22 applicable monitoring action requirements, it did not comply with 8 others, 2 of which it did not perform at all. Los Angeles complied with 9 of the 22 applicable monitoring action requirements but did not comply with 9 others.

For example, in fiscal year 1988 Tampa did not perform the monitoring actions for two procedures involving housing counseling agencies. Procedure no. 22 stipulates annual review and recertification of housing counseling agencies to ensure their continued qualification to provide services. In addition, procedure no. 21 stipulates certified housing counseling agencies that receive FHA grant funds to provide services must

⁵If (1) the office performed a procedure's monitoring action on time more than 95 percent of the time and (2) the office otherwise fulfilled all applicable aspects of a procedure's monitoring and corrective actions, the office was considered in compliance with that procedure.

⁶Procedure no. 20, Housing Counseling Agency Certification, did not apply to either Los Angeles or Tampa because neither office solicited housing counseling agencies or received applications in fiscal year 1988.

also receive semiannual site visits. Tampa did not perform annual reviews at any of its four housing counseling agencies in fiscal year 1988 and did not perform semiannual site visits at the one that had received grant funds. According to the Tampa Field Office Manager, the office did not perform annual reviews because he determined that other work, such as mortgagee reviews of assignment processing, should be given higher priority. The semiannual site visits were not performed, according to the Tampa Loan Management Chief, because he did not know that they were required.

Both offices incorrectly maintained the Owner-Occupant/Investor Condominium Log. The Housing and Urban-Rural Recovery Act of 1983 requires that at least 80 percent of the FHA-insured units in a condominium project be owner-occupied before FHA can insure financing on additional units. Neither field office correctly maintained a log for each condominium project, as required by the procedure. Los Angeles maintained its logs by land tract rather than project even though a land tract may include more than one project. Tampa's logs were incomplete because they did not include the loan issue date, which was needed to determine if the 80-percent requirement had been maintained throughout the year. Officials from both offices agreed that they were not properly performing this procedure and told us they would begin maintaining the logs correctly.

Monitoring Actions Not Documented So Compliance Unknown

We could not determine whether Tampa and Los Angeles complied with four monitoring action requirements in fiscal year 1988 because they had never documented the monitoring actions or documented them for only part of the year, or because performance documentation was either missing from their case files or the offices had not retained it.

FHA required documentation for one procedure that Tampa did not document—the procedure pertaining to supervisory field reviews of 5 percent of each appraiser's field reviews (no. 19). A supervisory field review (the second level of a two-tiered review process) entails reviewing the quality of field reviews performed by appraisers to ensure that they were performed in a fair and consistent manner and in accordance with HUD guidelines. According to the Tampa Valuation Branch Chief, she had performed supervisory field reviews but had not documented them or the results because of time constraints. Since she also had not kept a log, no documented evidence existed that these

reviews had been performed. She told us that she planned to begin documenting these reviews and results, both to prove they had been performed and to enable her to perform two required corrective actions that she had not been using.

Although counter to FMFIA's guidelines and GAO's internal control standards for system documentation, FHA did not require documentation for supervisory desk reviews of appraisals for either FHA-processed loans or direct endorsement loans. These two procedures entail reviewing the quality of desk reviews of appraisals performed by FHA staff appraisers. Officials from both field offices told us that they planned to develop logs that would document and track the performance results of the reviews.

Corrective Actions Not Taken as Required or Compliance Unknown

Los Angeles did not comply with 5 of 15 applicable corrective action requirements in the 22 applicable procedures. Tampa also did not take 8 of 16 applicable corrective actions. In addition, we could not determine Los Angeles' compliance with 10 corrective action requirements and Tampa's compliance with 5 because the corrective action or the monitoring action results were never documented, documentation was missing, or FHA's criteria were not sufficiently specific to ensure that corrective actions were taken consistently.

Actions Not Taken

For example, in fiscal year 1988 neither field office took certain corrective actions related to two procedures that are designed to monitor appraisal quality—nos. 18 and 19, field reviews and supervisory field reviews. The purpose of these two reviews is to ensure appraisal quality, a problem area previously identified by GAO.⁷ When field reviews rated appraisals by fee appraisers as "fair," Los Angeles and Tampa did not request written responses from the appraisers. In addition, Los Angeles did not place appraisers on test case status⁸ or remove the appraisers from the list of approved fee appraisers after three "poor" ratings. When supervisory field reviews rated field reviews as "fair" or "poor," Tampa did not, as required, request or hold meetings with the fee appraiser.

In fiscal year 1988, neither field office implemented Directive 52, as directed in a FHA memorandum dated December 17, 1987. The Los

⁷Internal Controls: Weaknesses in HUD's Single Family Housing Appraisal Program (GAO/RCED-87-165, Sept. 30, 1987).

⁸A period during which all appraisals prepared by an appraiser must receive FHA desk reviews (technical rather than on-site reviews).

Compliance With Corrective Actions Unknown

Angeles Valuation Branch Chief stated that he had not known of Directive 52 until late in 1989. According to the Tampa Valuation Branch Chief, she had been aware of Directive 52 in fiscal year 1988 but had not noticed that the required actions had changed. Both stated that they would fully comply with the directive.

Because Los Angeles had never documented four corrective actions and Tampa had never documented three, we were unable to determine compliance with the actions. All undocumented corrective actions involved three procedures related to appraisal quality (nos. 14, 15, and 18). For example, neither Los Angeles nor Tampa routinely documented that direct endorsement lenders took corrective action on all "fair" or "poor" ratings given to their staff appraisers or that meetings were held with fee appraisers with "poor" ratings. Tampa also did not document that fee appraisers with three "poor" ratings were placed on test case status.

In addition, because of very general corrective action criteria pertaining to deficient underwriting of direct endorsement loans, we were unable to determine whether Los Angeles used the four corrective actions (three probationary and one final) related to procedure no. 6 as it should have. FHA's unspecific criteria may also have contributed to Tampa's failure to take the required actions and to its meeting instead with the underwriters to improve their performance.

FHA's guidance for utilizing the probationary actions merely states that they may be used "when a mortgagee fails to comply with the [direct endorsement] program requirements" and that "depending upon the nature of the noncompliance with the requirements of the direct endorsement program the HUD field office may withdraw the approval of the noncomplying office [mortgagee] to participate in the program" as the final corrective action.

Conclusions

If the appropriate internal controls, or procedures, cannot be determined and used for needed monitoring—or if when they are used, their results are not documented for future use—the internal controls cannot be depended upon to protect the Section 203(b) program and the MMI Fund from fraud, waste, and mismanagement. FHA staff must be able to easily discern the appropriate procedures, with their attendant monitoring and corrective actions, so as to implement them fully, correctly, and in a timely fashion. This is impossible now because no single source or list of procedures exists. Adequate documentation would also allow FHA staff to determine if appropriate monitoring and corrective actions have been

performed and whether corrective actions taken have reduced the likelihood of program deficiencies.

Because of the limited nature of this review, its results are not attributable to other FHA offices. However, the distinct possibility exists, given FHA's previous indication that the Los Angeles and Tampa field offices would provide a fair basis for assessing field office performance, that other FHA field offices would have similar problems in monitoring the insurance program.

Recommendations to the Secretary of HUD

In order to improve implementation of the Section 203(b) monitoring system and to provide the information necessary to determine if appropriate monitoring and corrective actions have been taken, we recommend that you direct the Assistant Secretary for Housing—Federal Housing Commissioner, to

- develop a concise, easily updated list of the procedures for the Section 203(b) program's monitoring operation, indexed to more detailed guidance documents, and
- require documentation of the performance and results of all monitoring and corrective actions.

Agency Comments

We received written comments from HUD on a draft of this report (See app. IV). HUD agreed with our recommendations and stated that (1) during fiscal year 1991 its staff would compile a list of procedures for the Section 203(b) program's monitoring operation and (2) it was committed to more effective documentation of monitoring compliance. HUD did, however, take exception to our draft report's title, which indicated a broader scope than that covered by our audit; we modified the title to reflect the limited scope of our work. Moreover, recognizing the limited scope of our review, HUD believes that what is needed at this time is a thorough evaluation of the adequacy and cost-effectiveness of FHA's entire monitoring system. We agree that such an evaluation would be useful.

During the course of our work, we briefed HUD's former Assistant Secretary for Housing—Federal Housing Commissioner on the concept of our review. We also discussed the information in this report with the Deputy Assistant Secretary for Single Family Housing and with FHA officials in the Los Angeles and Tampa field offices. We appreciate the cooperation

we received from HUD officials during our audit. We conducted our review between February 1989 and July 1990 in accordance with generally accepted government auditing standards.

We will send copies of this report to the Assistant Secretary for Housing—Federal Housing Commissioner and to other interested parties and will make copies available to others upon request.

Please contact me on (202) 275-5525 if you have further questions. Major contributors to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in cursive script that reads "John M. Ols, Jr.".

John M. Ols, Jr.
Director, Housing and Community
Development Issues

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Abbreviations

CHUMS	Computerized Home Underwriting Management System
FHA	Federal Housing Administration
FMFIA	Federal Managers' Financial Integrity Act
GAO	U.S. General Accounting Office
HCA	housing counseling agency
HUD	Department of Housing and Urban Development
MMI	Mutual Mortgage Insurance Fund
SFDMS	Single Family Default Monitoring System
SFMNS	Single Family Mortgage Notes System

Objectives, Scope, and Methodology

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires that an agency's internal controls provide reasonable protection from fraud, waste, and mismanagement. Our concern about the Mutual Mortgage Insurance Fund's fiscal year 1988 loss, other recent losses in the Section 203(b) program, and a long-standing need to improve FHA's internal controls led us to review FHA's current method for monitoring the program, as part of our legislative responsibilities. We focused our review on FHA's programmatic internal controls over three of FHA's program areas—mortgage credit, valuation, and loan servicing. FHA's monitoring method has two components—reviews of individual cases, which we termed "procedures," and on-site reviews of lenders. Our review focused on the existing system's procedures, which generally include criteria for case selection, time frame of the procedure's monitoring action, and corrective actions for addressing deficiencies found.

Because FHA could not readily provide us with a comprehensive description of the current monitoring system, we first had to develop a comprehensive description of its method. In order to accomplish this task, we reviewed various materials including FHA policies, guidance, and procedures. We also interviewed officials with headquarters, regional offices, and field offices on numerous occasions.

As a result of this effort, we initially identified 25 procedures—23 designated for FHA field office performance and 2 for FHA headquarters. Neither of the two headquarters procedures included corresponding corrective actions, although 7 of the 23 field office procedures did. We obtained FHA comments on this list of 25 procedures, and we revised them in accordance with their review to ensure their completeness and accuracy.

We used the list of 25 procedures and information from 3 FHA national information systems—Computerized Home Underwriting Management System (CHUMS), Single Family Default Monitoring System (SFDMS), and Single Family Mortgage Notes System (SFMNS)—to review

- FHA's use of the procedures to (1) monitor applications from, and performance of, program participants, such as lenders, appraisers, and FHA staff, and (2) address deficiencies found during the assessment and
- FHA's documentation of the monitoring actions performed and any corrective actions taken.

Because of the difficulty involved in compiling the list of procedures, we focused our work in these two areas rather than attempt to assess the

effectiveness of individual procedures. Neither could we assess if the number of procedures was sufficient or if the individual procedures were extensive enough in their monitoring and corrective actions to ensure a reasonable protection against fraud, waste, and mismanagement.

In addition to its headquarters in Washington, D.C., FHA has 10 regional offices that encompass 72 field offices. Because the list of procedures was lengthy and we were interested in reviewing all of the listed procedures, we focused our review on two field offices. Our selection of field offices was based on volume of loan activity and geographic dispersion. Nationwide, 729,197 loans valued at \$44.3 billion were insured in fiscal year 1988. The field offices selected for review were Los Angeles, California (in Region IX—San Francisco, California), and Tampa, Florida (in Region IV—Atlanta, Georgia). In fiscal year 1988, Los Angeles insured 18,332 loans valued at \$1.5 billion, while Tampa processed 9,415 loans valued at \$513 million. FHA agreed that the use of these two offices constituted a fair basis for assessing field office performance.

We analyzed reports from FHA's national management information systems and from local field office logs. For all procedures for which a report or log was available, we reviewed the reports and logs from fiscal year 1988 and reviewed the files of relatively small judgmental samples of cases. However, the actual cases reviewed were randomly selected. We analyzed a sample of cases to determine compliance with the two headquarters procedures or monitoring action requirements. At the field offices, we analyzed compliance with the monitoring action requirements of 22 of the 23 field office procedures and with 15 and 16 of the 20 corrective action requirements in Los Angeles and Tampa, respectively. We considered an office to be in compliance with a procedure if (1) the office had performed monitoring actions on time more than 95 percent of the time (no corrective actions contained time frames) and (2) the office had otherwise completed all applicable aspects of the procedure's monitoring and corrective actions.

For each procedure's monitoring or corrective action listed in a management report or log, we used the list of all such procedures to select the cases in our judgmental sample. We then reviewed the files on the selected cases for evidence that the monitoring actions had been performed and corrective actions taken as required. Whenever the volume of activity was small enough, we reviewed all cases.

When we could not obtain a list of cases involving a procedure's monitoring or corrective action, we examined documentation on several cases provided by the FHA field offices at our request. We also reviewed any other available evidence to determine whether the procedure's monitoring action had been performed and the appropriate corrective action(s) taken. Where required monitoring had not been performed or specified corrective actions had not been taken, we discussed the reasons with responsible field office officials.

The rating system used by FHA field offices when performing field reviews of appraisals changed in December 1987, early in our review period, from a 3-point system—poor, fair, and good—to a 5-point system—1 (poor) to 5 (good). For continuity in our discussion, we used the 3-point rating system, in place at the beginning of our review period, throughout this report.

Because we visited only two field offices, the results of this review cannot be extended to all FHA field offices nationwide.

We conducted our audit work between February 1989 and July 1990 following generally accepted government auditing standards. We discussed our findings with officials of the Los Angeles field office in December 1989 and officials of the Tampa field office in January 1990. We have incorporated their comments into our report where appropriate. FHA officials in both locations agreed to take corrective actions on all of our findings.

Procedures for Monitoring FHA's Section 203(B) Insurance Program

During our review, we identified 25 procedures that FHA uses to monitor the mortgage credit, valuation, and loan management areas of the Section 203(b) insurance program. We reviewed FHA's compliance with and documentation of these 25 procedures, which are briefly described in this appendix.

Table II.1: FHA's Single Family Mortgage Insurance Monitoring Procedures

No.	Program area	Function	Level	Procedure
1	Mortgage credit	Lender approval	FO	Review of Lender Application
2	Mortgage credit	Lender approval	HQ	Lender's Approval
3	Mortgage credit	Lender recert.	HQ	Lender's Annual Recertification
4	Mortgage credit	Underwriting insur. process	FO	Preclosing Review for Direct Endorsement Lenders
5	Mortgage credit	Underwriting insur. process	FO	Pre-Endorsement Review for DE Loans
6	Mortgage credit	Underwriting	FO	Post-Endorsement Technical Review of Underwriting for DE Loans
7	Mortgage credit	Underwriting	FO	Approval of DE Lenders' Underwriter
8	Mortgage credit	Underwriting	FO	Firm Commitment Processing for FHA-Processed Loans
9	Mortgage credit	Underwriting	FO	Supervisory Review of Firm Commitment Processing for FHA-Processed Loans
10	Mortgage credit	Underwriting insur. process	FO	Cursory Endorsement Review for FHA-Processed Loans
11	Mortgage credit	Insurance processing	FO	Detailed Endorsement Review for FHA-Processed Loans
12	Valuation	Appraiser certification	FO	Approval of Fee and Lender-Staff Appraisers
13	Valuation	Appraiser annual recertification	FO	Fee Appraiser Annual Recertification
14	Valuation	Appraisal monitoring	FO	Conditional Commitment Processing Desk Review for FHA-Processed Loans
15	Valuation	Appraisal monitoring	FO	Post-Endorsement Technical Desk Review of Appraisals for DE Loans
16	Valuation	Appraisal monitoring	FO	Supervisory Desk Review of Appraisals for FHA-Processed Loans
17	Valuation	Appraisal monitoring	FO	Supervisory Desk Review of Appraisals for DE Loans
18	Valuation	Appraisal monitoring	FO	Field Review of Appraisals
19	Valuation	Appraisal monitoring	FO	Supervisory Field Review
20 ^a	Loan management	HCA Approval	FO	Housing Counseling Agency Certification
21	Loan management	Monitoring HCAs	FO	Housing Counseling Agency Semiannual Site Visits
22	Loan management	HCA recertification	FO	Housing Counseling Agency Annual Performance Review and Recertification
23	Loan management	Single family mortgage assign. processing	FO	Processing/Acceptance of Loan Assignment

(continued)

Appendix II
Procedures for Monitoring FHA's
Section 203(B) Insurance Program

No.	Program area	Function	Level	Procedure
24	Valuation	Condo. project applic. approval	FO	Condominium Project Approval
25	Mortgage credit	Monitoring condo. project investor ratio	FO	Owner-Occupant/Investor Condominium Log

Legend: FO = field office
 HQ = headquarters
 DE = direct endorsement

^aNeither Los Angeles nor Tampa solicited or received applications from housing counseling agencies in fiscal year 1988. Thus, this procedure was not applicable to them.

Procedure No. 1: Review of Lender Application

The FHA field office is to review a lender's application and substantiate documents to determine if the lender meets FHA's experience, net worth, and credit requirements to participate in FHA programs. Within 15 days of receiving an application, the field office sends headquarters a memorandum recommending lender approval or disapproval.

Procedure for corrective action not needed.

Procedure No. 2: Lender's Approval

Headquarters (Office of Lender Activities, Lender Approval and Recertification Division) is to review all lenders' applications submitted by the field offices with recommendation for approval or disapproval (proc. no. 1). All documents are reviewed to determine each lender's eligibility to participate in the Section 203(b) program and to ensure that they have been completed in accordance with FHA guidelines. An unapproved lender may not participate in the program. An approved lender must follow FHA guidance and undergo periodic review (proc. no. 3).

Procedure for corrective action not needed.

Procedure No. 3: Lender's Annual Recertification

Headquarters (Office of Lender Activities, Lender Approval and Recertification Division) is to annually update its data on the status of all lenders. This update verifies receipt of annual fees and reviews financial statements and other submissions in accordance with the lender's category. The verification and review serve to determine if a lender is still qualified to originate FHA-insured loans. If so, the lender is recertified. If not, the lender is notified of its withdrawal from the list of approved FHA lenders.

Procedure for corrective action not needed.

Procedure No. 4: Pre-Closing Review for Direct Endorsement Lenders

The field office is to review the underwriting in 15 test cases (loan packages), submitted by a lender, prior to unconditional approval to process loans directly as a direct endorsement lender. Each test case must be reviewed within 3 days of receipt. A field office may reduce or eliminate a lender's test cases if the lender was previously approved by another field office. If the original 15 cases are not underwritten satisfactorily, the lender may submit more loan packages until 15 satisfactory ones have been reviewed.

Procedure for corrective action not needed.

Procedure No. 5: Pre-Endorsement Review for Direct Endorsement Loans

Field offices are to briefly review all direct endorsement loans, prior to issuing an FHA Mortgage Insurance Certificate, to ensure that the loan meets minimum FHA and statutory requirements. All direct endorsement packages must be reviewed within 10 days of receipt.

Procedure for corrective action not needed.

Procedure No. 6: Post-Endorsement Technical Review of Underwriting for Direct Endorsement Loans

Field offices are to review a varying percentage of each direct endorsement lender's loans to ensure maintenance of underwriting quality. (The percentage varies from 10 to 100 percent of loans depending on such factors as the lender's early default and claim rates and results of field reviews.) This review and the post-endorsement review of appraisals (proc. no. 15) are to be performed on the same cases within 20 days of their receipt.

The field office is to use one or more of three probationary corrective actions when a lender fails to comply with direct endorsement requirements:

- place lender on pre-closing review status (proc. no. 4),
- require additional training, and
- require revision of quality control plan.

If the field office determines that the probationary action(s) has been ineffective, it may withdraw direct endorsement status as the fourth corrective action.

**Procedure No. 7:
Approval of Direct
Endorsement Lenders'
Underwriters**

The field office is to review, and approve or reject, the applications of all underwriters on the staff of direct endorsement lenders. These reviews are to ensure that the underwriters are (1) qualified, reliable, and responsible professionals skilled in mortgage risk evaluations; (2) familiar with market conditions in the geographic areas where mortgage loans will be originated; and (3) have the authority to reject unacceptable risks and to direct technical staff concerning compliance with FHA's underwriting requirements.

Procedure for corrective action not needed.

**Procedure No. 8: Firm
Commitment
Processing for FHA-
Processed Loans**

For all FHA-processed loans, the field office is to review the borrower's credit history and approve or reject the borrower for the loan within 3 days of the loan package's receipt.

Procedure for corrective action not needed.

**Procedure No. 9:
Supervisory Review of
Firm Commitment
Processing for FHA-
Processed Loans**

The field office is to review at least 1 in 10 Firm Commitment Reports (proc. no. 8) for all FHA loan specialists to ensure they are processing loans in accordance with FHA guidelines. The review results serve as input to the individual loan specialist's annual performance appraisal.

No corrective action specified.

**Procedure No. 10:
Cursory Endorsement
Review for FHA-
Processed Loans**

The field office performs a cursory review of each FHA-processed loan package to ensure that all documents necessary for closing the loan and qualifying for FHA insurance have been enclosed. The cursory review and the detailed review (proc. no. 11) are to be completed within 10 days of the loan package's receipt.

Procedure for corrective action not needed.

**Procedure No. 11:
Detailed Endorsement
Review for FHA-
Processed Loans**

The field office is to review in detail 10 percent of FHA-processed loans for each lender to re-verify that the closing documents are present and to determine if other required documents supporting that outstanding loan conditions have been satisfied are also present. These documents include a termite control certificate, completed repairs certificate, insured protection plan warranty, health authority approval, code compliance inspection report, and a seller's certificate. Both the cursory (proc. no. 10) and the detailed reviews are to be completed within 10 days of loan package receipt.

Procedure for corrective action not needed.

**Procedure No. 12:
Approval of Fee and
Lender-Staff
Appraisers**

The field office is to review approval applications for each fee appraiser and lender-staff appraiser to determine if the applicant is qualified to perform appraisals. Applicants also must have certified that they will not appraise property in which they have a personal interest and will comply with FHA procedures in preparing and submitting appraisal reports.

Procedure for corrective action not needed.

**Procedure No. 13:
Annual Recertification
of Fee Appraisers**

The field office is to review the performance of all fee appraisers annually to determine if they have complied with FHA requirements and are, therefore, still qualified to perform appraisals for FHA.

Procedure for corrective action not needed.

**Procedure No. 14:
Conditional
Commitment
Processing (Desk
Review) for FHA-
Processed Loans**

The field office is to review all appraisals for mathematical accuracy, adequacy of adjustments made in determining property value, reasonableness, and completeness. A conditional commitment form must be prepared for each appraisal reviewed.

If the FHA appraiser identifies questionable information during the review, a field review of the appraisal must be requested (proc. no. 18).

**Procedure No. 15:
Post-Endorsement
Technical (Desk)
Review of Appraisals
for Direct
Endorsement Loans**

The field office is to review the same direct endorsement loans selected for underwriting review under procedure no. 6 to determine if the appraisals were adequate. The technical review of the appraisals is performed to verify completeness, mathematical accuracy, adequacy of adjustments made in determining property value, and reasonableness. The field office is to perform both the post-endorsement review of underwriting and the post-endorsement review of the appraisal within 20 days of receipt.

If the FHA staff appraiser identifies questionable information during the review, a field review of the appraisal must be requested (proc. no. 18).

**Procedure No. 16:
Supervisory Desk
Review of Appraisals
for FHA-Processed
Loans**

The field office is to review the quality of desk reviews (proc. no. 14) of appraisals performed by FHA staff appraisers for FHA-processed loans. Neither a specific number of reviews nor documentation of the reviews and their results is required. Review results serve as input to annual performance evaluations of the FHA staff appraisers.

No corrective action is specified.

**Procedure No. 17:
Supervisory Desk
Review of Appraisals
for Direct
Endorsement Loans**

The field office is to review the quality of desk reviews (proc. no. 15) of appraisals performed by FHA staff appraisers for direct endorsement cases. No specific number of reviews or documentation of the reviews and their results is required. The results are to serve as input to the annual performance evaluations of the FHA staff appraisers.

No corrective action is specified.

**Procedure No. 18:
Field Review of
Appraisals**

The field office is to perform field (on-site) reviews on appraisals prepared by staff appraisers of direct endorsement lenders and by fee appraisers to ensure that the appraisers are preparing reliable appraisals that truly reflect the property values. Ten percent of all appraisals and 5 percent of each appraiser's appraisals must be reviewed.

If a staff appraiser of a direct endorsement lender receives a rating of "fair" or "poor," the field office is to send a copy of the field review report and a letter (if used) to the lender requesting corrective action. FHA can refuse appraisals from staff appraisers whose appraisals are

unacceptable and can remove the lender's direct endorsement status if no corrective action is taken. (2 corrective actions)

If a fee appraiser receives a "fair" rating, the field office is to send the appraiser a copy of the field review report and a letter instructing the appraiser to provide a written response. A fee appraiser with a "poor" rating is to receive a copy of the field review report and a letter with instructions to make an appointment to meet with the field office within 15 days. The field office is to obtain the written responses to "fair" ratings within 15 days and meet with the fee appraiser to discuss "poor" ratings. After three "poor" ratings, FHA's Chief Appraiser must institute short-term training, during which the fee appraiser will be given only a limited number of cases that can be monitored closely (test case status) or remove the fee appraiser from the fee panel. (5 corrective actions)

Procedure No. 19: Supervisory Field Review

The field office is to review the quality of appraisal field reviews performed under procedure no. 18 and to use the Field Review Report form to document the supervisory review and results. Five percent of each FHA staff appraiser's and fee field review appraiser's work must be reviewed on an annual basis. For FHA staff appraisers, the results are to be reflected in the annual performance evaluations.

If a fee field review appraiser receives a "fair" or "poor" rating, the field office is to send the appraiser a letter with instructions to contact the office within 15 days and make an appointment to discuss the rating. The field office is then to discuss the rating with the appraiser. If performance does not improve, the field office is to remove the appraiser from the fee field review panel. (3 corrective actions)

Procedure No. 20: Housing Counseling Agency Certification

The field office is to review applications from housing counseling agencies to determine if the counseling agency is qualified and meets FHA's eligibility requirements. (A housing counseling agency is a public or private entity approved by HUD to provide counseling and advice to existing and potential housing consumers on, among other things, how to avoid mortgage default and foreclosure.)

Procedure for corrective action not needed.

Procedure No. 21: Housing Counseling Agency Semiannual Site Visits

The field office is to visit (1) housing counseling agencies in the first year after initial certification and (2) those housing counseling agencies that receive grant funds every 6 months to ensure that they are performing in accordance with FHA's guidelines and the grant agreement. These visits involve observing and evaluating counseling activities, reviewing funding sources, and verifying invoices to support records. A findings letter must be prepared for each site visit.

As a corrective action, the field office is to issue a findings letter within 30 days after a site visit. Within another 30 days, the housing counseling agency is to respond in writing and provide evidence that any findings have been corrected. The counseling agency requirement to respond, however, is not in FHA guidance and appears to be only an informal policy. (2 corrective actions)

Procedure No. 22: Housing Counseling Agency Annual Performance Review and Recertification

The field office is to conduct an annual, comprehensive on-site review of housing counseling agencies' activity. The annual visits involve

- reviewing staffing allocations and training, adequacy of space and location for classes, annual budget attributable to counseling, funding sources, and vouchers for claims;
- observing counseling interviews with clients; and
- conducting file reviews.

If the housing counseling agency did not receive a grant, the field office is not required to review funding sources or vouchers for claims. Findings letters and responses from 6-month site visits (proc. no. 21) and performance throughout the year are also considered in making the recertification decision.

The field office is to issue a findings and recommendations letter to the housing counseling agency within 30 days of the annual site visit. (The field office may perform the annual review concurrently with a semiannual site visit. In this case a separate findings letter and response would not be required.) Within another 30 days, the housing counseling agency is to provide, in writing, evidence of those findings that have been corrected. The counseling agency requirement to respond, however, is not in FHA guidance and appears to be only an informal policy. (2 corrective actions)

**Procedure No. 23:
Processing/
Acceptance of Loan
Assignment**

The field office is to review all requests for assignment of loans to the Secretary-held portfolio and make one of three decisions within 90 days of receipt: (1) If a determination is made that a lender was negligent in servicing the loan or cannot foreclose because of a borrower's bankruptcy, the field office must return the case to the lender for further servicing; (2) If accepted, the borrower is notified and FHA begins monitoring and servicing the loan; or (3) If adequate documentation is not provided with the request, the borrower is issued a preliminary rejection letter and must meet with the field office within 25 days of the preliminary rejection date—if on the basis of the additional information the loan still does not qualify for acceptance, the field office sends a final rejection letter to the borrower.

Procedure for corrective action not needed.

**Procedure No. 24:
Condominium Project
Approval**

The field office is to review all condominium project applications and determine if they are eligible to participate in the FHA program. The requirements that must be met include presale requirements, owner-occupancy requirements for project approval, owner-occupancy requirements for FHA-insured mortgages, and completion of construction.

Procedure for corrective action not needed.

**Procedure No. 25:
Owner-Occupant/
Investor Condominium
Log**

The field office is to determine if the condominium unit is in an FHA-approved project and satisfies the owner-occupant/investor ratio requirement prior to regular processing. At least 80 percent of the FHA-insured mortgages to date in a project must be owner-occupied before a unit can be insured for an investor. The field office is required to maintain a log for each project. Direct endorsement lenders must call the field office to determine if the project is approved and to determine if the 80-percent requirement is met.

Procedure for corrective action not needed.

Overall Assessment of Applicable Procedure Implementation in Los Angeles and Tampa for Fiscal Year 1988

After our identification of the initial 25 monitoring procedures, we reviewed their use by the Los Angeles and Tampa field offices in (1) monitoring the applications from, and the performance of, Section 203(b) program participants and (2) addressing any deficiencies found during the monitoring process. If the individual field office performed a procedure's monitoring and corrective action(s) on time more than 95 percent of the time and otherwise completed all applicable aspects of an action, the field office was considered to be in compliance with the procedure and/or the corrective action. As shown in tables III.1 and III.2, Los Angeles complied with 9 of 22 applicable procedures but with none of the 15 applicable corrective action requirements. Tampa complied with 10 of 22 applicable procedures and with 3 of 16 applicable corrective action requirements. Either the remainder of the procedures and corrective action requirements were not complied with or their status was undeterminable because the field offices lacked documentation or because FHA's criteria were unclear.

Table III.1: Overall Implementation Assessment of Applicable Monitoring (22) And Corrective (15) Actions in Los Angeles for Fiscal Year 1988

Monitoring actions and, when applicable, corrective actions	Compliance results		Reasons for "unknown" results
	Of procedure	Of corrective action	
1 Review of Lender Application	Noncompliance		
4 Pre-closing Review for Direct Endorsement (DE) Lenders	Noncompliance		
5 Pre-Endorsement Review for DE Loans	Compliance		
6 Post-Endorsement Technical Review of Underwriting for DE Loans	Noncompliance		
Corrective action			
1. Pre-closing review status		Unknown	Unclear criteria
2. Additional training		Unknown	Unclear criteria
3. Review of quality control plan		Unknown	Unclear criteria
4. Withdrawal of DE approval		Unknown	Unclear criteria
7 Approval of DE Lenders' Underwriter	Compliance		
8 Firm Commitment Processing for FHA-Processed Loans	Compliance		
9 Supervisory Review of Firm Commitment of FHA-Processed Loans	Unknown		Procedure not documented for part of year
10 Cursory Endorsement Review for FHA-Processed Loans	Compliance		
11 Detailed Endorsement Review for FHA-Processed Loans	Noncompliance		
12 Approval of Fee and Lender Staff Appraiser	Compliance		

(continued)

**Appendix III
Overall Assessment of Applicable Procedure
Implementation in Los Angeles and Tampa
for Fiscal Year 1988**

Monitoring actions and, when applicable, corrective actions	Compliance results		Reasons for "unknown" results
	Of procedure	Of corrective action	
13 Annual Recertification of Fee Appraisers	Compliance		
14 Conditional Commitment Processing Desk Review for FHA-Processed Loans	Compliance		
Corrective action			
1. Field review		Unknown	No documentation of corrective action
15 Post-Endorsement Technical Desk Review of Appraisals for DE Loans	Noncompliance		
Corrective action			
1. Field review		Unknown	No documentation of corrective action
16 Supervisory Desk Review of Appraisals for FHA-Processed Loans	Unknown		No documentation of procedure
17 Supervisory Desk Review of Appraisals for DE Loans	Unknown		No documentation of procedure
18 Field Review of Appraisers	Noncompliance		
Corrective action			
DE lender's appraiser:			
1. Field review report and letter to lender		Unknown	Documentation missing from files
2. FHA may refuse to accept appraisals or remove lender's DE status		Unknown	No documentation of lender's corrective action
Fee appraiser:			
3. Letter instructing appraiser with "fair" rating to provide written response within 15 days		Noncompliance	
4. Letter instructing appraiser with "poor" rating to meet with FHA field office within 15 days		Unknown	Documentation missing from file
5. Written response on "fair" rating within 15 days		Noncompliance	
6. Meeting with appraiser to discuss "poor" rating		Unknown	No documentation of corrective action
7. After 3 "poor" ratings required placement of appraiser on test case status or removal from fee panel		Noncompliance	
19 Supervisory Field Review	Unknown		Procedure not documented for part of year
Corrective action			
1. Field review report and letter instructing appraiser to contact field office within 15 days to arrange meeting		Not apply ^a	
2. Meeting with appraiser		Not apply ^a	

(continued)

**Appendix III
Overall Assessment of Applicable Procedure
Implementation in Los Angeles and Tampa
for Fiscal Year 1988**

Monitoring actions and, when applicable, corrective actions	Compliance results		Reasons for "unknown" results
	Of procedure	Of corrective action	
3. Removal		Not apply ^a	
21 Housing Counseling Agency (HCA) Semiannual Site Visit	Noncompliance		
Corrective action			
1. Findings letter within 30 days of site visit		Noncompliance	
2. HCA written response within 30 days		Noncompliance	
22 HCA Annual Performance Review and Recertification	Noncompliance		
Corrective action			
1. Findings letter within 30 days of site visit		Not apply ^b	
2. HCA written response within 30 days		Not apply ^b	
23 Processing/Acceptance of Loan Assignment	Compliance		
24 Condominium Project Approval	Compliance		
25 Owner-Occupant/ Investor Condominium Log	Noncompliance		
Total Compliance Results:			
Compliance	9	0	
Noncompliance	9	5	
Unknown	4	10	
	22	15	

^aNo fee field review appraisers were used in FY 1988.

^bHCA annual reviews were performed concurrently with site visits. Separate findings letters and responses were thus not required.

**Appendix III
Overall Assessment of Applicable Procedure
Implementation in Los Angeles and Tampa
for Fiscal Year 1988**

Table III.2: Overall Implementation Assessment of Applicable Monitoring (22) And Corrective (16) Actions in Tampa for Fiscal Year 1988

Monitoring actions and, when applicable, corrective actions	Compliance results		Reasons for "unknown" results
	Of procedure	Of corrective action	
1 Review of Lender Application	Noncompliance		
4 Pre-closing Review for Direct Endorsement (DE) Lenders	Compliance		
5 Pre-Endorsement Review for DE Loans	Compliance		
6 Post-Endorsement Technical Review of Underwriting for DE Loans	Compliance		
Corrective action			
1. Pre-closing review status		Noncompliance	
2. Additional training		Noncompliance	
3. Review of quality control plan		Noncompliance	
4. Withdrawal of DE approval		Noncompliance	
7 Approval of DE Lenders' Underwriter	Compliance		
8 Firm Commitment Processing for FHA-Processed Loans	Compliance		
9 Supervisory Review of Firm Commitment of FHA-Processed Loans	Unknown		Procedure documentation not retained and not tracked
10 Cursory Endorsement Review for FHA-Processed Loans	Noncompliance		
11 Detailed Endorsement Review for FHA-Processed Loans	Noncompliance		
12 Approval of Fee and Lender Staff Appraiser	Compliance		
13 Annual Recertification of Fee Appraisers	Compliance		
14 Conditional Commitment Desk Review Processing for FHA-Processed Loans	Compliance		
Corrective action			
1. Field review		Compliance	
15 Post-Endorsement Technical Desk Review of Appraisals for DE Loans	Compliance		
Corrective action			
1. Field review		Compliance	
16 Supervisory Desk Review of Appraisals for FHA-Processed Loans	Unknown		No documentation of procedure
17 Supervisory Desk Review of Appraisals for DE Loans	Unknown		No documentation of procedure
19 Field Review of Appraisers	Noncompliance		
Corrective action			

(continued)

**Appendix III
Overall Assessment of Applicable Procedure
Implementation in Los Angeles and Tampa
for Fiscal Year 1988**

Monitoring actions and, when applicable, corrective actions	Compliance results		Reasons for "unknown" results
	Of procedure	Of corrective action	
DE lender's appraiser:			
1. Field review report and letter to lender		Compliance	
2. FHA may refuse to accept appraisals or remove lender's DE status		Unknown	No documentation of DE
Fee appraiser:			
3. Letter instructing appraiser with "fair" rating to provide a written response within 15 days		Noncompliance	
4. Letter instructing appraiser with "poor" rating to meet with FHA field office within 15 days		Unknown	Documentation missing from files
5. Written response on "fair" rating within 15 days		Noncompliance	
6. Meeting with appraiser to discuss "poor" rating		Unknown	No documentation of corrective action
7. After 3 "poor" ratings, required placement of appraiser on test case status or removal from fee panel		Unknown	No documentation of corrective action
19 Supervisory Field Review	Unknown		No documentation of procedure
Corrective action			
1. Field review report and letter instructing appraiser to contact field office within 15 days to arrange meeting		Noncompliance	
2. Meeting with appraiser		Noncompliance	
3. Removal		Unknown	No documentation of procedure results
21 Housing Counseling Agency (HCA) Semi-annual Site Visit	Noncompliance		
Corrective action			
1. Findings letter within 30 days of site visit		Not apply ^a	
2. HCA written response within 30 days		Not apply ^a	
22 HCA Annual Performance Review and Recentrification	Noncompliance		
Corrective action			
1. Findings letter within 30 days of site visit		Not apply ^a	
2. HCA written response within 30 days		Not apply ^a	
23 Processing/Acceptance of Loan Assignment	Noncompliance		
24 Condominium Project Approval	Compliance		

(continued)

Appendix III
Overall Assessment of Applicable Procedure
Implementation in Los Angeles and Tampa
for Fiscal Year 1988

Monitoring actions and, when applicable, corrective actions	Compliance results		Reasons for "unknown" results
	Of procedure	Of corrective action	
25 Owner-Occupant/ Investor Condominium Log	Noncompliance		
Total Compliance Results:			
Compliance	10	3	
Noncompliance	8	8	
Unknown	4	5	
	22	16	

^aTampa did not perform HCA semiannual site visits or annual reviews

Comments From the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410 8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

OCT - 4

Mr. John M. Ols, Jr.
Director, Community and Economic
Development Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Ols:

Your August 22, 1990, letter to Secretary Kemp which transmitted the draft GAO report, "Federal Housing Administration: Monitoring of Single Family Mortgages Not Complete (GAO/RECD-90-223)," has been referred to me for reply. Your audit focused on the extent to which HUD was monitoring activity under FHA's 203(b) program, addressing deficiencies revealed through such monitoring, and documenting the monitoring process as well as any corrective actions taken.

In visits to two field offices (Tampa and Los Angeles), you found a numerous examples of either (1) noncompliance with, or (2) failure to document actions taken under, our established monitoring procedures. These findings are summarized below:

	Los Angeles	Tampa
<u>Monitoring procedures:</u>		
Full compliance	9	10
Not full compliance	9	8
Unknown/not documented .	4	4
Total applicable ...	22	22
<u>Corrective actions:</u>		
Full compliance	0	3
Not full compliance	5	8
Unknown/not documented .	10	5
Total applicable ...	15	16

This memorandum formally transmits our comments on the draft report, as discussed by our respective staffs in a meeting held on August 29, 1990.

Appendix IV
Comments From the Department of Housing
and Urban Development

(1) Need for a monitoring summary. In the course of the audit, GAO identified 32 separate monitoring procedures that are being used by FHA in Headquarters and the field under its home mortgage insurance programs. This is an impressive number of procedures, and your auditors correctly note that these various monitoring activities are not summarized in a single, readily accessible document. Therefore, you recommend that FHA:

"... develop a concise, easily updated list of the procedures for the Section 203(b) program's monitoring operation, indexed to more detailed guidance documents ..." (p. 14).

I agree with this suggestion, and during FY 1991, FHA staff will compile such a listing. This focus on FHA's overall monitoring effort will give senior management an excellent opportunity to evaluate the way we currently monitor our programs. It will also enable us to determine whether all of our current monitoring requirements are needed or effective.

(2) Interpretation of audit results. Your audit finds a disturbing incidence of noncompliance with existing FHA monitoring requirements. The field offices reviewed have agreed to take corrective actions on all of your findings, and we do not disagree with your overall assertion that all of the current FHA monitoring requirements are not being carried out on a consistent basis in many of our field offices. However, you also note that:

"Because of the effort required to compile the list of procedures, we focused our work on [the use of procedures and documentation of corrective actions] rather than an attempt to assess the effectiveness of individual procedures. Neither could we assess if the number of procedures was sufficient or if the individual procedures were extensive enough in their monitoring and corrective actions to ensure a reasonable protection from fraud, waste, and mismanagement abuse." (Underlining added)

Given the limited scope of your audit, I am therefore troubled by the way that your findings have been portrayed. The title, for example, states that "Monitoring of Single Family Mortgages [is] Not Complete"—a conclusion that is hardly justified on the basis of your findings. What clearly is needed at this point is a thorough evaluation of what FHA needs to do to assure effective monitoring in a cost-effective manner.

It may well be that a review of this sort will lead to greater emphasis on overall lender performance and accountability and reduced loan-by-loan monitoring. A system that has 32 separate monitoring procedures needs more than a better means of cataloguing the procedures. We need to rationalize our monitoring requirements and set priorities—so that field office managers understand what is expected of them, and can accomplish effective monitoring within available staffing and resource constraints.

See comment 1.

Appendix IV
Comments From the Department of Housing
and Urban Development

(3) Documentation requirements. Aside from instances where specific monitoring procedures or corrective actions are not being performed, your audit places considerable weight on the need for documentation and clearly delineated corrective actions. Thus, you recommend that FHA:

"require documentation of the performance and results of all monitoring and corrective actions."

I agree that improved documentation is important. The failure of field offices to document the actions they have taken seriously limits our ability to track their performance or evaluate the effectiveness of our monitoring programs. I would point out that our recently issued study of the Direct Endorsement program recommends the institution of a formal reporting system on corrective actions taken by field offices against DE lenders. We are committed to more effective documentation of monitoring compliance.

On the other hand, I believe that your audit is misleading in the way it deals with an alleged lack of "corrective actions." For example, to quote from the summary in your report:

"PROCEDURE NO. 1: REVIEW OF LENDER APPLICATION

"The FHA field office is to review a lender's application and substantiating documents to determine if the lender meets FHA's experience, net worth, and credit requirements to participate in FHA programs. The field office sends a memo to headquarters within 15 days of applications receipt, recommending lender approval or disapproval. (Underlining added)

"No corrective action is specified." (pp 23-24)

It appears from your finding that you believe that some additional action is needed--over and above disapproval of the lender--in instances where the field office determines noncompliance with our standards. In our opinion, a recommendation of disapproval is an automatic "corrective action."

In 18 of the 25 monitoring procedures you have examined, your audit concludes that: "No corrective action is specified." We have reviewed your comments, and find that fully 15 of the 18 procedures fall into the same category as Procedure No. 1 cited above--i.e., the procedure itself involves a review and subsequent approval or disapproval. In all 15 of these instances, a finding of unacceptable performance automatically results in a refusal to endorse the loan, a finding of ineligibility to participate in the program, or some other form of serious sanction.

See comment 2.

Appendix IV
Comments From the Department of Housing
and Urban Development

To cite another example of where we disagree, you state:

"PROCEDURE NO. 5: PRE-ENDORSEMENT REVIEW FOR DIRECT
ENDORSEMENT LOANS

"Field offices are to briefly review each direct endorsement loan, prior to issuing an FHA Mortgage Insurance Certificate, to ensure that the loan meets minimum FHA and statutory requirements. The loan is insured or rejected within 10 days of receipt. If a loan is rejected, the lender has an opportunity to resolve the reasons for rejection and have the loan insured.

"No corrective action is specified." (p. 25)

Again, it is difficult to imagine a more effective "corrective action" than FHA's refusal to endorse the loan for insurance.

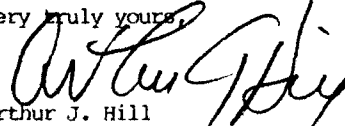
We agree that better documentation is needed in the three procedures which involve supervisory review of processing. But we disagree in the remaining 15 instances where rejection of the applicant or application is itself a corrective action. Unless you can explain what added documentation is needed, we conclude that very act of rejecting a loan for insurance or denying a request for program participation is, on its face, evidence that an effective job of monitoring has been performed.

Finally, you are similarly critical of FHA's policy of granting field offices flexibility in administering sanctions. For example, since FHA handbooks provide a range of sanctions that can be taken against lenders who abuse the Direct Endorsement program, you argue that field offices should be given specific rules on the application of each sanction, based on a pre-determined number of "fair" or "poor" review ratings. I believe that this level of micro-management is unproductive.

Field offices should take prompt, timely and aggressive action against those who abuse our programs, but they also need flexibility and judgment in dealing with program participants on a case-by-case basis. Rigid rules or formulaic approaches to monitoring are no substitute for experience and common sense. Thus, while supporting better documentation and reporting, FHA would oppose a more rigid monitoring system that removes discretion for field office managers.

While disagreeing in some respects, let me compliment you on the thorough job your staff has done in listing FHA monitoring procedures, and in pointing up areas where we can improve. Please contact Ellie Clark, on 401-8800, if you have any questions concerning this memorandum.

Very truly yours,



Arthur J. Hill
Acting Assistance Secretary for
Housing-Federal Housing Commissioner

See comment 3.

GAO Comments

1. We agreed with the HUD comment that the title of the draft report sent to the agency for their review and comment is misleading because it conveyed the impression that HUD's monitoring system is not sufficient to ensure a reasonable protection from fraud, waste, and mismanagement abuse. As noted in the report, we did not focus on the overall adequacy of the monitoring system but rather on the compliance with, and documentation of, existing procedures. The title of the final report has been changed to "Monitoring of Single Family Mortgages Needs Improvement" to better reflect this more limited focus. Further, while a study of the overall adequacy and cost-effectiveness of FHA's existing monitoring system may be warranted, given recent losses to the program, any changes made to FHA's monitoring system in response to such a study would not change the basic conclusions of this report. Internal control procedures must be clearly and concisely documented so that FHA staff know what procedures to follow and to ensure that they have been adequately performed.

2. We also agree that the use of the phrase "No corrective action is specified" is misleading in those cases where the application of the procedure itself results in a corrective action. We were not making the point that some further corrective action should be required. After a review of the 25 monitoring procedures contained in appendix II we have, for 15 procedures, changed the report language to read "Procedure for corrective action not needed".

3. Regarding the HUD final comment in which the agency disagrees with our statement that HUD's guidance is unclear on when field offices should take corrective action, we would like to make two points. First, nowhere in the report do we conclude that "field offices should be given specific rules on the application of each sanction, based on a predetermined number of fair or poor review ratings." Nor do we recommend that HUD begin such a practice. Secondly, while we agree that the need for flexibility exists in any monitoring system to adjust to individual circumstances and cases, guidance should not be so unclear that one cannot determine when it should be applied or, as in the case of the Tampa field office, not applied at all.

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Related GAO Products

Financial Audit: Federal Housing Administration Fund's 1988 Financial Statements (GAO/AFMD-90-36, Feb. 9, 1990).

Financial Audit: Federal Housing Administration Fund's 1987 Statement of Financial Position (GAO/AFMD-89-3, May 12, 1989).

Financial Management: Federal Housing Administration's Accounting Methods and Section 203(b) Program (GAO/AFMD-89-26BR, May 5, 1989).

Housing Programs: HUD Policies to Minimize Costs in Acquiring Foreclosed Properties (GAO/RCED-88-141BR, Apr. 18, 1988).

Internal Controls: Weaknesses in HUD's Single Family Housing Appraisal Program (GAO/RCED-87-165, Sept. 30, 1987).

Housing Programs: Agency Actions to Discourage Single Family Mortgage Insurance Fraud (GAO/RCED-86-172BR, June 3, 1986).

HUD's Second-Year Implementation of the Federal Managers' Financial Integrity Act (GAO/RCED-86-22, Oct. 8, 1985).

Stronger Internal Controls Over HUD Single-Family Mortgage Insurance Programs Would Discourage Fraud (GAO/RCED-85-4, May 13, 1985).

Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management (GAO/RCED-84-9, Jan. 10, 1984).