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SINGLE-FAMILY HOUSING

Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk

Statement of Stanley J. Czerwinsld, Associate Director,
Housing and Community Development Issues,
Resources, Community, and Economic Development Division

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Madame Chairman and Members of the Subcommittee:

We are here to discuss our report that you requested and are releasing today on the Department of Housing and Urban Development's (HUD) oversight of lenders that make mortgage loans insured by HUD's Federal Housing Administration (FHA).[1] During fiscal year 1999 alone, FHA insured 1.3 million mortgages valued at about $124 billion. While FHA insures lenders against nearly all losses resulting from foreclosed loans, it relies on the lenders to underwrite the loans and determine their eligibility for FHA mortgage insurance.

Our review focused on the adequacy of HUD's policies and procedures for overseeing lenders. We performed limited tests and analyses to determine whether these policies and procedures were properly utilized to limit HUD's insurance risk.

In summary, our work revealed a number of weaknesses in the lender approval, monitoring, and enforcement efforts performed by HUD's headquarters and its four homeownership centers.[2]

- HUD's process for granting FHA-approved lenders direct endorsement authority-that is, the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review-provides only limited assurance that lenders receiving this authority are qualified.

- In addition, while HUD's homeownership centers have monitored lenders' compliance with FHA's lending requirements, these monitoring efforts have not adequately focused on the lenders and loans that pose the greatest insurance risks to the Department.

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[1] *Single-Family Housing: **Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk*** (GAO/RCED-00-112, Apr. 28, 2000).

[2] HUD's four homeownership centers administer the single-family housing functions in the 50 states, the District of Columbia, and Puerto Rico. The centers are located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania, and Santa Ana, California.

- Finally, although HUD has taken enforcement actions against lenders with excessively high default rates, it needs to take further steps to hold lenders accountable for poor performance and program violations.

Our report makes recommendations designed to improve HUD's processes for approving lenders to underwrite FHA-insured mortgages, for targeting lenders and loans for quality control reviews, and for taking enforcement actions against poorly performing lenders. In commenting on the report, HUD stated that it generally agreed with the report's recommendations.

Background

A homebuyer seeking a FHA-insured mortgage must submit a mortgage application to a FHA-approved lender. Once the lender approves the loan, it sends the loan documents to HUD for approval of FHA mortgage insurance. If the borrower defaults and the lender subsequently forecloses on the loan, the lender can file an insurance claim with HUD for the unpaid balance of the loan. As of December 1999, about 10,000 lending institutions were approved to participate in FHA's mortgage insurance programs for single-family homes.

Most FHA-approved lenders are authorized to originate FHA-insured loans, meaning that they can accept mortgage applications, obtain employment verifications and credit histories on applicants, order property appraisals, and perform other tasks that precede the loan underwriting process. Approximately 2,900 of the FHA-approved lending institutions also have direct endorsement authority, meaning that they can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review. Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan. Direct endorsement lenders may underwrite loans that either they originated or were originated by other lenders. Lenders with direct endorsement authority underwrite virtually all FHA-insured mortgages for single-family homes.

Direct Endorsement Approval Process Provides Limited Assurance That Lenders Are Qualified

HUD's process for granting FHA-approved lenders direct endorsement authority-the ability to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review-provides only limited assurance that lenders receiving this authority are qualified. HUD's guidance does not adequately define the level of proficiency that lenders must achieve in order to be granted direct endorsement authority. As a result, HUD's homeownership centers have applied the guidance differently and have approved lenders that made multiple and serious underwriting errors.

FHA-approved lenders seeking direct endorsement authority go through a probationary period during which they are required to demonstrate acceptable performance in underwriting at least 15 mortgage loans. The mortgages are submitted to and evaluated by HUD's homeownership centers before the mortgages are finalized. These evaluations rate as "good," "fair," or "poor" various aspects of the lender's work, including its analysis of the credit risk posed by the borrower and the quality of the property appraisal. A "poor" rating indicates that the lender made underwriting errors that significantly increased HUD's insurance risk.

While HUD's guidance requires that lenders seeking direct endorsement authority demonstrate overall acceptable performance on these evaluations, the guidance is unclear on what constitutes "acceptable performance." As a result, HUD's homeownership centers have interpreted the guidance differently. For example, the Denver center interpreted the guidance to mean that lenders had to submit 15 mortgages for which they received at least "good" or "fair" ratings. In contrast, the Santa Ana center did not have a requirement for the number of "good" and "fair" ratings that lenders had to achieve.

HUD's four homeownership centers granted direct endorsement authority to a total of 36 lenders during the 6 months prior to our 1999 visits to the centers. We reviewed the ratings that each of these lenders received from the centers for the lender's evaluation of the credit risk posed by the borrower. Our analysis showed significant variations in what HUD's homeownership centers considered as acceptable performance, reflecting the vagueness and inconsistent application of HUD's approval standards. Overall, of the 36 lenders, 8 received no "poor" ratings for the last 15 mortgages they submitted to the centers for review. However, 12 lenders received "poor" ratings in over a quarter of their last 15 mortgages. The lenders' errors included their failure to (1) verify the borrower's employment and income, (2) ensure that the borrower had sufficient income to support the monthly mortgage payments, (3) explain delinquent accounts and collections on the borrower's credit reports, and (4) properly calculate the borrower's debts or liabilities. We believe that lenders such as these 12 may pose a high insurance risk to the Department once they begin underwriting and approving loans without HUD's prior reviews.

To improve HUD's process for granting lenders direct endorsement authority, our report recommended that HUD develop specific performance standards for lenders seeking this authority.

Monitoring Process Does Not Adequately Focus on Riskiest Lenders and Loans

HUD's homeownership centers use two monitoring tools to ensure lenders' compliance with FHA's lending requirements: (1) on-site evaluations of lenders' operations, known as *lender* reviews, and (2) desk audits of the underwriting quality of loans already insured by FHA, known as *technical* reviews. HUD's guidance stresses the importance of using risk analysis to allocate a larger share of monitoring resources to program activities that pose the highest risks to the Department. However, the homeownership centers have **not** adequately focused their monitoring efforts on lenders and loans that pose the highest insurance risks.

<u>HUD Has Reviewed More Lenders in Recent Years but Often Not the Riskiest Ones</u>

In recent years, HUD has placed greater emphasis on performing on-site evaluations of lenders' operations. For example, the number of lender reviews that HUD performed grew from 291 in fiscal year 1996 to 932 to in fiscal year 1999. HUD's guidance states that 85 percent of the lender reviews should be targeted at high-risk lenders. However, we found that the homeownership centers often did not review the lenders that they considered to pose the highest risks. For example, the Philadelphia center developed a list of 131 high-risk lenders that it considered to be a high priority for review in fiscal year 1999. Despite conducting reviews of 228 lenders during fiscal year 1999, the center reviewed just 39-or about 30 percent-of the 131 lenders on its priority list. While the other homeownership centers did not have similar priority lists, center officials told us that they frequently selected for review those lenders that did not pose a high insurance risk to HUD. For instance, a Santa Ana center official estimated that half of the reviews the center performed in fiscal year 1999 were of lenders that had few or no early defaults-that is, loans that defaulted within 24 months. Because loans that default this quickly are an indicator of poor lending practices that may result in insurance losses, HUD considers them to be an important factor in assessing lenders' risk.

Homeownership center officials cited inexperienced staff and limited or uncertain travel funds as reasons why high-risk lenders were not always reviewed. For instance, according to the four homeownership centers, most of the centers' 140 staff who conduct lender reviews assumed their current positions in fiscal years 1998 and 1999--largely from the pool of HUD field staff who remained unassigned after HUD's 1998 reorganization. Center officials also told us that they generally did not allow staff with less than a year of experience to review high-risk lenders because their inexperience might lead them to overlook serious deficiencies.

Furthermore, although HUD's guidance states that lenders should be rated and prioritized for review, the Department has not developed a systematic process for doing so. HUD's guidance lists several risk factors that should be considered in targeting lenders for reviews, including default rates, the late payment of mortgage insurance premiums to HUD, and the volume of business. But the guidance indicates neither how these factors should be weighted nor how lenders should be prioritized. As a result, the centers have not targeted lenders for reviews in a consistent manner. To more effectively monitor lenders' performance, our report recommends that HUD develop procedures to identify and prioritize high-risk lenders for lender reviews and ensure that the homeownership centers consistently apply these procedures.

Selection of Loans for Technical Reviews Was Not Based on Risk

Technical reviews-desk audits that evaluate the underwriting quality of loans already insured by FHA--are another tool that HUD uses to monitor the performance of lenders. If technical reviews reveal serious deficiencies, HUD may suspend the lenders' authority to underwrite FHA-insured loans, among other things.

All four of HUD's homeownership centers met the Department's goal to perform technical reviews on no less than 10 percent of the FHA-insured mortgage loans made during fiscal year 1999. However, the centers have not effectively implemented HUD's guidance, which states that technical reviews should be targeted at loans that exhibit high-risk characteristics, such as loans to borrowers with unusually high expenses relative to their income. Instead, HUD's homeownership centers rely primarily on a random process for selecting loans for technical reviews. The computer system that supports HUD staff in processing mortgage insurance randomly selects a certain percentage of each lender's loans for technical reviews. However, the system cannot automatically identify and select for review those loans that exhibit high-risk characteristics. HUD's four homeownership centers told us that they sometimes manually selected high-risk loans for reviews but that the large volume of loans that they processed for FHA insurance, coupled with staffing constraints, made it impractical to do this on a routine basis. To address this problem, our report recommends that HUD enhance its management information systems to identify and select, for technical reviews, loans that pose a high insurance risk to the Department.

Efforts to Hold Lenders Accountable for Poor Performance Have Not Been Sufficient

To hold lenders accountable for program violations or poor performance, HUD may, among other things, (1) suspend their direct endorsement authority and (2) terminate their loan origination authority through its Credit Watch program, which is designed to hold lenders accountable for excessive defaults and insurance claims on FHA-insured mortgages. However, the homeownership centers have made only limited use of their ability to suspend lenders' direct endorsement authority. Furthermore, certain lenders have escaped accountability under the Credit Watch program.

Homeownership Centers Made Limited Use of Their Ability to Suspend Lenders' Direct Endorsement Authority

HUD's guidance allows the homeownership centers to suspend the direct endorsement authority of lenders that fail to comply with FHA's program requirements but provides only general guidelines for determining which lenders should be subject to this action. Lenders whose direct endorsement authority is suspended must submit their mortgage case files to the homeownership centers, which evaluate the lenders' underwriting decisions before deciding whether to insure the loans.

Among the four homeownership centers, we found that the Philadelphia center was the only one that had suspended the direct endorsement authority of any lenders during fiscal year 1999. Specifically, the Philadelphia center took this action against eight lenders in fiscal year 1999, citing underwriting violations identified by technical reviews or lender reviews. Although the centers suspended relatively few lenders, our analysis of HUD's technical review ratings for fiscal year 1999 showed frequent noncompliance with FHA's underwriting requirements, indicating that many lenders may be candidates for this action. Specifically, we identified 206 lenders nationwide that, during fiscal year 1999, received "poor" ratings on more than 30 percent of their reviewed loans for their evaluation of the credit risk posed by the borrower.[3] A "poor" rating means that the lender made mistakes that significantly increased HUD's insurance risk. Of these 206 lenders, 131 made 10 or more FHA-insured loans in fiscal year 1999. HUD's guidance does not specify the extent of noncompliance with FHA's requirements that would warrant the suspension of a lender's direct endorsement authority. However, in our opinion, the extent of noncompliance demonstrated by these 131 lenders indicates that they may be candidates for this action. As of October 1, 1999, HUD's homeownership centers had not suspended any of these lenders.

To strengthen HUD's enforcement efforts against lenders, our report recommends that HUD clarify and implement guidelines for identifying lenders whose direct endorsement authority should be suspended.

Lenders Underwriting Loans Originated bv Others Escape Responsibility for Excessive Default and Claim Rates Under HUD's Credit Watch Program

In May 1999, HUD announced that it would begin to use its Credit Watch program to sanction lenders with excessive defaults and insurance claims on FHA-insured mortgages. HUD planned to terminate the loan origination authority of any lender whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeded both the national average and 300 percent of the average rate for the HUD field office serving the lender's geographic location. Similarly, HUD planned to place on "credit watch" status the lenders whose default and claim rates exceeded both the national average and 200 percent of the corresponding HUD field office average. While on "credit watch" status, the lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD.

[3]The 206 lenders were among the approximately 5,000 lenders that received technical review ratings in fiscal year 1999 for mortgages they both originated and underwrote.

As of April 2000, HUD had completed four rounds of its Credit Watch program. This program has resulted in the Department's actual or proposed termination of 64 lenders' loan origination authority and the placement of 140 additional lenders on "credit watch" status.

The regulations governing HUD's Credit Watch program allow the Department to hold accountable for excessive defaults or insurance claims the lenders that originated the troubled loans. However, the regulations do not address HUD's authority to also hold accountable those lenders that underwrote the loans. When originating mortgage loans, lenders perform such functions as accepting mortgage applications and obtaining employment verifications and credit reports on the borrowers. When underwriting mortgage loans, lenders use this information to determine whether borrowers are able to make their mortgage payments and whether the loans should be approved. HUD officials told us they recognized that the underwriting lenders contributed to excessive defaults and insurance claims but that the Credit Watch program's regulations did not permit them to take enforcement actions against these lenders. The officials said they were considering regulatory changes to address this problem.

The results of the first round of the Credit Watch program illustrate the program's limitations as an enforcement tool. Of the 33 lenders that HUD terminated during the first round of the program, 17 relied on other lenders to underwrite the nearly 6,200 loans that they originated and FHA insured during the 24month period of analysis. Nevertheless, the underwriting lenders escaped sanctions under the Credit Watch program.

The Credit Watch program is also facing a legal challenge. In September 1999, one lender whose authority to originate FHA-insured mortgage loans was terminated by HUD filed a lawsuit seeking to overturn HUD's actions. Among other issues, the lender contended that HUD had exceeded its statutory authority when it issued its Credit Watch regulations and that the manner in which HUD terminated the lender's authority had deprived the lender of due process. In October 1999, a federal district court ruled that HUD's Credit Watch regulations were invalid and set aside HUD's termination of the lender. The court stated that HUD's statutory authority requires that after determining that a lender has excessive defaults and claims, HUD must provide the lender with the opportunity to provide the Department with a plan and timetable for correcting the defaults. The court stated that HUD had sidestepped its statutory mandate by enacting regulations that allowed the Department to terminate a lender's authority to originate loans whenever HUD deemed it appropriate because of the lender's default and claim rates. The court also concluded that even if HUD had the authority to issue such regulations, the regulations denied the lender its right to due process. HUD has appealed the court's decision. In May 2000, another lender successfully sought a court injunction that prevented HUD from terminating this lender's authority to originate FHA-insured mortgages. Our report recommends that once the legal basis of the Credit Watch program is resolved, HUD revise the program's regulations to cover lenders that underwrite FHA-insured loans with excessive defaults and claims rates as well as those lenders that originate such loans.

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Madame Chairman, this concludes our testimony. We would be happy to answer any questions that you or members of the Subcommittee may have.

Contact and Acknowledgement

For further information regarding this testimony, please contact Stanley J. Czerwinski at (202) 512-7631. Individuals making key contributions to this testimony included Karen Bracey, Karin Lennon, Stan Ritchick, Paul Schmidt, Steve Westley, and Shana Whitehead.

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