



March 12, 2021

MEMORANDUM NO:
2021-KC-0801

Memorandum

TO: Julie Shaffer
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FROM: Ronald J. Hosking
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SUBJECT: Key Considerations From Prior Audits of the Single Family Default Monitoring System and the Partial Claim Loss Mitigation Option

We prepared this memorandum to provide the Office of Housing at the U.S. Department of Housing and Urban Development (HUD) with key considerations from prior audits of the HUD Single Family Default Monitoring System (SFDMS) and the partial claim loss mitigation option. These audits identified HUD's lack of effective controls to ensure that lenders reported default information accurately and in a timely manner, lenders promptly filed and reported partial claims, and partial claims fully reinstated delinquent loans. Prior audits also identified that the current design of partial claims results in an inferior lien position on the securing property during a foreclosure sale. HUD should address these situations now to ensure program integrity and minimize the risk of financial loss during the novel coronavirus (COVID-19) national emergency.

HUD's challenges with default reporting could impact its ability to report to Congress, establish a budget, and evaluate policy effectiveness and potential policy changes. Default reporting issues could also hinder HUD in determining the actual number of borrowers seeking and obtaining forbearance assistance due to the COVID-19 national emergency. Further, if HUD had challenges with partial claims during the periods audited, it might have serious challenges during the COVID-19 national emergency, given the substantial number of loans in forbearance and the delinquency status and timing of many of the forbearance periods ending at the same time. If HUD does not expedite corrective actions from prior audits, it may experience financial loss due to its inability to evaluate policy effectiveness and initiate required policy changes and from improper or uncollectible partial claims.

BACKGROUND AND METHODOLOGY

On March 27, 2020, the President signed the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) into law. The CARES Act provides a mortgage payment forbearance option for all borrowers who, either directly or indirectly, suffer a financial hardship due to the COVID-19 national emergency. Under the CARES Act, borrowers are entitled to request an initial forbearance of their monthly mortgage payments for up to 180 days and may request up to an additional 180 days. For the borrowers who requested their initial COVID-19 forbearance on or before June 30, 2020, if needed, the borrower may request, and the mortgagee must approve up to two additional three-month COVID-19 forbearance periods. The Federal Housing Administration (FHA) does not require lump-sum repayment at the end of the forbearance and has developed the COVID-19 stand-alone partial claim to assist with repayment.

A partial claim is a payment from FHA to the lender to bring the loan current, with an offsetting zero interest, no fee, junior lien on the borrower’s property that will become payable when the borrower sells the home or pays off the mortgage or the mortgage otherwise terminates. If the borrower does not qualify for the COVID-19 stand-alone partial claim, FHA offers other tools to help reinstate the mortgage, including other COVID-19 Home Retention Options and the FHA-Home Affordable Modification Program (FHA-HAMP) loss mitigation options.

SFDMS is HUD’s system for tracking lender data on delinquent mortgages until a delinquency is resolved through reinstatement or termination. The lender must report in SFDMS the delinquency or default status codes that accurately reflect the stage of delinquency or lender action. Lenders are required to submit accurate SFDMS reports to HUD. This requirement includes reporting the accurate default status of each loan as well as the reason for the default.

Due to the current circumstances during the COVID-19 national emergency, FHA will likely face an extraordinary increase in the number of partial claims it will need to process in the next year. According to information reported by lenders in HUD’s SFDMS, in January 2021, approximately 1.18 million FHA-insured loans were reported as delinquent, in forbearance, natural disaster, or in foreclosure moratorium, compared to 571,000 loans in January 2020. We are unable to predict how many of these loans will require a partial claim to be reinstated to a current status and what the amount of these partial claims will be, but we expect it will be a significant increase from the prior volume. According to the loss mitigation data maintained by HUD, in the last 3 years, FHA has processed and paid on average nearly 46,000 partial claims per year. The following table summarizes recent information from SFDMS.

Delinquency code description	January 2020 count	January 2021 count
Delinquent	532,620	292,933
Formal forbearance	13,365	803,072
Special forbearance	6,370	1,979
Natural disaster	24,949	51,721
Foreclosure moratorium	1,713	265,818
*Adjusted total	570,793	1,181,557

*Lenders reported some loans with more than one delinquency code during the reporting month. The adjusted totals reflect the unique number of loans after removing the duplicates.

To prepare this memorandum, we reviewed relevant CARES Act criteria, HUD mortgagee letters, and prior audits of HUD's default reporting system and partial claims. We also reviewed prior audit recommendations in HUD's Audit Resolution and Corrective Action Tracking System. In addition, we analyzed data in SFDMS.

KEY CONSIDERATIONS DURING COVID-19

Considerations Regarding SFDMS

HUD has not developed and implemented additional system error checks to identify potential default reporting issues. This weakness might lead to inaccurate forecasting of loan performance as these forecasts rely on data reported by SFDMS. In addition, HUD has not implemented better controls and edits within SFDMS to ensure more accurate and timely information from the lenders. HUD's ability to report to Congress, establish a budget, and evaluate policy effectiveness and potential policy changes is dependent upon complete, accurate, and timely default reporting. If HUD does not expedite corrective actions from prior audits, it may experience financial loss due to improper reporting to Congress and the inability to evaluate policy effectiveness or initiate required policy changes. Default reporting issues could also hinder HUD in determining the actual number of borrowers seeking and obtaining assistance due to the COVID-19 national emergency.

HUD needs to modernize SFDMS as it is relying on a default monitoring system designed and built in the 1970s, which it stated is possibly cost prohibitive to revise and redesign. Relying on an outdated system could lead to HUD's making decisions based on inaccurate information. HUD has already agreed to replace the system with a more modern and robust system.

Considerations Regarding Partial Claims

HUD has not established deadlines for filing partial claims, which will create uncertainty for forecasting upcoming claims against the fund and may also create issues when applying the criteria for frequency of partial claims. HUD should update its guidance with the deadlines for filing partial claims before it receives an influx of partial claims following COVID-19 forbearances.

HUD has paid partial claims that did not reinstate the loan to a current status. It will be critical that partial claims are properly applied following the forbearance period to ensure that borrowers are no longer delinquent on their mortgages. HUD has clarified the guidance related to COVID-19 partial claims so the borrowers will benefit from the partial claim by having their mortgage delinquency cured. However, HUD should still expedite the Single Family Claims system upgrades to prevent lenders from submitting improper partial claims that do not reinstate the mortgage. HUD can use additional funding from the CARES Act to address system deficiencies.

HUD has designed the partial claims loss mitigation option in a way that causes the partial claims to lose lien priority when the amount is removed from the first mortgage and made a secondary lien. In addition, partial claims are separately tracked and serviced. These conditions add to the risk of nonrecovery and highlight the benefit of redesigning partial claims to remain a part of the first mortgage. If HUD is able to address prior audit recommendations before lenders start processing COVID-19 partial claims, it will better protect its interests.

PRIOR AUDITS

Prior audits of HUD's default reporting system and partial claims found issues that should be addressed as soon as possible to ensure program integrity and mitigate the risk of financial loss in the COVID-19 environment.

Prior Audit of SFDMS

[2013-KC-0003, Single Family Housing Reporting of Defaults \(September 10, 2013\)](#)

In this report, we found that HUD did not have effective controls to ensure that lenders reported default information accurately and in a timely manner. HUD's controls included only minimal system error codes to detect potential issues within the data submitted; basic monitoring of error code rates, nonreporting, and underreporting; and lender servicing reviews examining a sample of default information at selected lenders. HUD also did not have an adequate penalty process in place to deter future issues. The system had six fatal error codes, which caused records to be rejected; however, these codes were narrowly defined to catch only a handful of possible reporting issues. The system also had several nonfatal errors. These codes generally indicated that data fields were not provided but did not prevent the records from being submitted to the system. As a result, the default data were not always accurate and timely. Our analysis of 18 months of default data identified multiple issues, including failure to report in a timely manner, failure to report on loans when required, failure to report loans when they were 30 days delinquent, illogical sequences in the oldest unpaid installment date, and failure to determine the reason for default. HUD relied on default data to stay up to date on the status and trends of insured mortgages and to identify potential risk to the insurance fund.

HUD has not yet addressed the recommendation to develop and implement additional system error checks to identify potential reporting issues in SFDMS. The Office of Housing at HUD is planning to modernize its systems and replace SFDMS altogether instead of merely enhancing the existing system. The Office of Housing has established the project timelines to complete system enhancements, which include the replacement of SFDMS in phase 1 of the project. The expected completion date is July 31, 2021.

This issue may result in HUD's obtaining inaccurate information about the use of COVID-19 relief programs offered by HUD and is especially important as HUD uses the default reporting data to monitor the effectiveness of its programs and to forecast how the FHA fund will perform.

Prior Audits of Partial Claims

[2020-AT-0801, HUD Had Not Established Deadlines for Reporting FHA-HAMP Nonincentivized Loan Modifications and Filing Nonincentivized Partial Claims \(February 4, 2020\)](#)

In this report, we found that HUD's FHA-HAMP loss mitigation policy did not include deadlines to ensure timely reporting for nonincentivized loan modifications and filing of nonincentivized partial claims. Nonincentivized means that the lender did not receive an incentive payment from HUD for completing the action. The lenders were not obligated to always report or report in a timely manner nonincentivized loan modifications and file or file in a timely manner nonincentivized partial claims in FHA Connection. HUD needs to establish a policy for

reporting the terms of nonincentivized loan modifications and filing the nonincentivized partial claims within specified timeframes or deadlines.

HUD has not yet addressed recommendation 1A to update HUD's loss mitigation policies, to include deadlines for the servicers to file the FHA-HAMP nonincentivized partial claims and consider imposing sanctions for noncompliance with these deadline requirements. In addition, HUD still needs to address recommendation 1B to update HUD's loss mitigation policies, to include deadlines for the servicers to report the new terms of the FHA-HAMP nonincentivized loan modifications and consider imposing sanctions for noncompliance with these deadline requirements. HUD is currently working on an update to the Single Family Handbook 4000.1, which will address this audit. It plans to publish the revised handbook within the next four to six months.

This issue might affect borrowers who will try to apply for an FHA-HAMP loss mitigation option at the end of their COVID-19 forbearance period. HUD allows borrowers to receive an FHA-HAMP loss mitigation option only if they had no other FHA-HAMP agreements executed in the past 24 months. If a borrower had an initial FHA-HAMP loss mitigation claim delayed, he or she might lose out on eligibility at the end of the forbearance.

[2019-KC-0001, FHA Improperly Paid Partial Claims That Did Not Reinstate Their Related Loans \(April 11, 2019\)](#)

In this report, we found that HUD was paying partial claims that did not reinstate the delinquent mortgages to a current status. A partial claim must reinstate its related delinquent loan to a current state. The mortgage account must have no payments that are due and unpaid after the partial claim funds are applied to the mortgage. However, in most of the cases in our audit sample, the loans remained 1 month delinquent after receiving the partial claim, while the rest ranged from 2 to 11 months delinquent. HUD's claims processing system was outdated and did not have an edit check, which would prevent an improper partial claim that did not cure the loan's delinquency from being processed. FHA also did not determine whether a loan was reinstated by the partial claim as part of its postclaims review or quality assurance review.

HUD has not yet addressed recommendation 1B to design controls to protect the insurance fund from improper partial claims that did not reinstate the loans. To address this recommendation, HUD plans to replace the claims subsystem and the default monitoring system by July 2021. In addition, HUD still needs to address recommendation 1C to update the FHA-HAMP guidance, clarifying that upon application of the partial claim funds, the mortgage must be fully reinstated with no unpaid amounts. HUD is currently working on an update to the Single Family Handbook 4000.1, which will address this audit. It plans to publish the revised handbook within the next four to six months.

This issue is particularly important to the borrowers experiencing hardship due to the COVID-19 national emergency. HUD needs to ensure that COVID-19 stand-alone partial claims and FHA-HAMP partial claims following forbearances fully reinstate delinquencies so the borrowers can be brought current on their payments.

[2018-KC-0004, HUD Did Not Always Identify and Collect Partial Claims Out of Surplus Foreclosure Proceeds \(September 20, 2018\)](#)

In this report, we found that HUD did not always identify and collect partial claims out of surplus proceeds from nonconveyance foreclosures. In these situations, the properties went into foreclosure and were sold to a third party at the foreclosure auction rather than being sold to the lender for conveyance to HUD. Of the 81 foreclosures reviewed, 32 had nearly \$768,000 in surplus proceeds that HUD did not recover. This situation occurred because HUD's partial claim was in an inferior lien position on the securing property. Additionally, the partial claims were not serviced by the FHA lender, so the FHA lender did not make a claim on HUD's behalf when the associated property was sold in a foreclosure sale.

HUD has not yet addressed recommendation 1B to implement a policy to require servicers to send surplus proceeds notifications to the HUD Secretary-held assets servicing contractor and establish procedures to improve HUD's surplus proceeds collection efforts. To address this recommendation, HUD will publish a mortgagee letter or a handbook update, advising servicers and their attorneys to forward the notice of surplus proceeds from a foreclosure sale to HUD. In addition, HUD still needs to address recommendation 1C to redesign the partial claim program to eliminate its program weaknesses, ensuring that partial claims would benefit from a stronger lien position. To address this recommendation, HUD stated that, due to competing priorities with the COVID-19 national emergency, its Office of General Counsel has been unable to provide its opinion on the viability of redesigning the program, but it extended the due date of the recommendation to April 10, 2021.

This issue is important, as HUD is preparing for an unprecedented number of partial claims within the next year and under the current design of partial claims, HUD's position will be weakened by these claims.

CRITERIA

Section 4022 of the [CARES Act](#) allows a borrower with a federally backed mortgage loan experiencing financial hardship due, directly or indirectly, to the COVID-19 emergency to request forbearance on the federally backed mortgage loan, regardless of delinquency status, by (1) submitting a request to the borrower's lender and (2) affirming that the borrower is experiencing a financial hardship during the COVID-19 emergency. Lenders are required to grant such forbearance for a period of 180 days and extend it for an additional 180 days at the request of the borrower, provided that at the borrower's request, either the initial or extended period of forbearance may be shortened. Additionally, this section places a 60-day foreclosure moratorium on foreclosure actions unless the property is vacant. This moratorium became effective on March 18, 2020.

HUD informed lenders of the deadline for approving the initial COVID-19 forbearance and related extensions to the deadline through a series of mortgagee letters (ML 2020-06, ML 2020-34, ML 2020-44, ML 2021-04, and ML 2021-05). HUD informed lenders of the timeframe for the foreclosure and eviction moratorium and related extensions to the moratorium through a series of mortgagee letters (ML 2020-04, ML 2020-13, ML 2020-19, ML 2020-27, ML 2020-43, ML 2021-03,

and ML 2021-05). These mortgagee letters extend both the date to begin an initial COVID-19 forbearance and the foreclosure and eviction moratoriums through June 30, 2021.

HUD [Mortgagee Letter 2020-06](#) (issued April 1, 2020, and effective immediately) also informed lenders of special loss mitigation home retention options available to single-family borrowers affected by the COVID-19 national emergency. For any borrowers receiving a forbearance because they were affected by the COVID-19 national emergency, lenders must evaluate the borrowers for the COVID-19 national emergency stand-alone partial claim no later than the end of the forbearance period(s). The mortgagee letter states that the lender must not deny COVID-19 national emergency home retention options to borrowers who experience an adverse impact on their ability to make on-time mortgage payments due to the COVID-19 national emergency and satisfy the loss mitigation criteria set forth in Handbook 4000.1. Lenders must ensure certain eligibility requirements for the borrowers and confirm specific terms of the COVID-19 partial claim. A lender must evaluate any borrower not brought current through a COVID-19 national emergency stand-alone partial claim option for other loss mitigation home retention options and home disposition options. The mortgagee letter also requires that lenders report the default or delinquency reason codes that apply to the borrower at the end of each reporting cycle and update the code as the borrower's circumstances change.

HUD [Mortgagee Letter 2020-13](#) (issued May 14, 2020, and effective immediately) also announced new SFDMS reporting requirements. Lenders were required to immediately begin reporting default status code 06 – formal forbearance in SFDMS for borrowers who requested forbearance assistance. HUD also required that the new delinquency and default reason (DDR) code 055 – related to national emergency declaration be used to report that the delinquency was a result of impacts of the COVID-19 pandemic. In the interim, all lenders that were unable to report DDR code 055 for the April 2020 cycle must report DDR code 010 – neighborhood problem until they can begin reporting DDR code 055. Lenders must fully implement reporting of DDR code 055 no later than the July 2020 reporting cycle. These data were due to HUD no later than August 7, 2020, which was the fifth business day of August 2020.

HUD [Mortgagee Letter 2021-05](#) (issued on February 16, 2021, and effective immediately) also informed lenders of an extension to the deadline for the first legal action and the reasonable diligence time frame to 180 days. The mortgagee letter also provided up to two additional three-month COVID-19 forbearance periods for certain borrowers and allowed additional borrowers, regardless of delinquency status or participation in a COVID-19 forbearance, to utilize FHA's COVID-19 loss mitigation options. The mortgagee letter also removed the restriction on borrowers receiving more than one COVID-19 home retention option and advised servicers that COVID-19 partial claims and loan modifications must fully reinstate the loan.