OFFICE OF AUDIT
REGION 5
CHICAGO, IL

U.S. Department of Housing and Urban Development, Office of Single Family Housing Washington, DC

Single Family Housing Program Property-Flipping Waiver

2014-CH-0001 **SEPTEMBER 30, 2014**

Issue Date: September 30, 2014

Audit Report Number: 2014-CH-0001

TO: Kathleen Zadareky, Deputy Assistant Secretary for Single Family Housing, HU

//**signed**//

FROM: Kelly Anderson, Regional Inspector General for Audit, Chicago Region, 5AGA

SUBJECT: HUD Did Not Always Provide Adequate Oversight of Its Property-Flipping Waiver Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's oversight of its property-flipping waiver requirements.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at (312) 353-7832.

September 30, 2014

HUD Did Not Always Provide Adequate Oversight of Its Property-Flipping Waiver Requirements

Highlights

Audit Report 2014-CH-0001

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) oversight of property flipping as part of the activities in our fiscal year 2013 annual audit plan, which includes contributing to the protection of the integrity of housing insurance and guarantee programs. Our audit objective was to determine whether HUD had adequate oversight of its property-flipping waiver.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require lenders to (1) support or indemnify HUD for any future losses on 12 loans with an estimated loss of $1 million (2) indemnify HUD for any future losses on 16 loans with an estimated loss of $1.5 million. We also recommend that HUD (1) discontinue the waiver or strengthen its controls over its property-flipping waiver requirements and (2) issue clarification on the criteria for determining a loan's sales contract date and a property's resale date to ensure consistent and accurate application by lenders.

What We Found

HUD did not always (1) ensure that lenders complied with the additional underwriting conditions to be eligible for a waiver from its 90-day property-flipping regulation and (2) properly identify or track loans for 90-day property flips. As a result of these deficiencies, the risk to FHA's Mutual Mortgage Insurance Fund increased by more than $2.5 million. Further, HUD lacked assurance of the accuracy of the property-flipping data, which provided the basis for its decision to extend the waiver through 2014. We estimate that over the next year, if HUD does not implement our recommendations, the potential risk to the FHA Mutual Mortgage Insurance Fund will be nearly $274 million for properties not meeting eligibility requirements for a waiver of HUD's property-flipping regulation.

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BACKGROUND AND OBJECTIVE

The Federal Housing Administration (FHA) provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single-family and multifamily homes, including manufactured homes and hospitals. It is the largest insurer of mortgages in the world, having insured more than 34 million properties since its inception in 1934. FHA mortgage insurance provides lenders protection against losses as a result of homeowners defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender if a homeowner defaults. Loans must meet certain requirements established by FHA to qualify for insurance.

The term ***property flipping*** refers to a practice in which a recently acquired property is resold for a considerable profit with an artificially inflated value, often abetted by a lender's collusion with an appraiser. Most property flipping occurs within a matter of days after acquisition and usually with only minor cosmetic improvements, if any. To prevent this abuse, the U.S. Department of Housing and Urban Development (HUD) instituted 24 CFR (Code of Federal Regulations) 203.37a(b)(2), prohibiting the use of FHA financing to purchase single-family properties that are resold within 90 days of acquisition.

In January 2010, FHA announced that it was waiving its regulation that prohibited the use of FHA financing to purchase properties that were resold within 90 days of acquisition. The waiver,[1] which applied to all sales contracts executed on or after February 1, 2010, has been gradually extended over the years through December 31, 2014.

FHA, through the regulatory waiver, sought to encourage investors that specialize in acquiring and renovating properties to renovate foreclosed-upon and abandoned homes with the objective of increasing the availability of affordable homes for first-time and other purchasers. This effort would help stabilize real estate prices as well as neighborhoods and communities where foreclosure activity has been high.

To be eligible for the waiver of HUD's property-flipping regulation, an FHA-approved lender must meet certain conditions. For example, all transactions must be arms length, and for a property that is sold more than 20 percent above the seller's acquisition cost, the lender is eligible for the waiver only if it

1. Justifies the increase in value by retaining in the loan file a second appraisal or supporting documentation, which verifies that the seller has completed sufficient legitimate renovation, repair, and rehabilitation, and
2. Orders a property inspection and provides the inspection report to the purchaser before closing. Further, starting February 1, 2011, if the inspection report noted that repairs were

[1] The waiver does not apply to sales by HUD of real estate-owned properties or mortgages insured under HUD's Home Equity Conversion Mortgage program.

required because of structural or "health and safety" issues, those repairs must be completed before closing.

In 2011, HUD published an initial assessment of the waiver. The assessment included an analysis of early payment defaults, borrowers' credit profiles, and property defects for property flips in comparison to loans for non-property flips to ensure that FHA risk controls were adequate.

Further, HUD's Office of Evaluations performed an analysis of the waiver, which focused on the percentage of HUD real estate-owned properties[2] that were sold to purchasers using an FHA-insured loan and the percentage of flipped properties that were purchased using FHA insurance as of June 30, 2012. This analysis concluded that the waiver had no perceptible impact on FHA's insured portfolio as the share of real estate owned sales to owner occupants using FHA insurance had not changed nor had the percentage of real estate-owned sales that came back to FHA as new originations within 90 days of disposition.

HUD's Office of Single Family Housing is responsible for the overall management and administration of the FHA single-family mortgage insurance programs and provides guidance for and oversight of the lenders that participate in its mortgage insurance programs. Its oversight authorities include HUD's Homeownership Centers, which are located in Philadelphia, PA, Denver, CO, Santa Ana, CA, and Atlanta, GA. Within the Homeownership Centers is the Processing and Underwriting Division. The Processing and Underwriting Division performs postendorsement technical reviews to ensure that lenders understand and comply with HUD's requirements. To execute this function, the Division reviews selected mortgages after endorsement. This process includes a review of the appraisal report, mortgage credit analysis, underwriting decisions, and closing documents from the mortgage case endorsement file.

Our objective was to determine whether HUD had adequate oversight of its property-flipping waiver. Specifically, we wanted to determine whether HUD (1) ensured that lenders complied with required conditions to be eligible for the waiver and (2) properly identified or tracked 90-day property flips.

[2] A real estate-owned property is a residential property acquired by HUD as a result of a foreclosure action on an FHA-insured mortgage. In this case, HUD becomes the property owner and offers it for sale to recover the loss on the foreclosure claim.

RESULTS OF AUDIT

Finding: HUD Did Not Always Ensure That Lenders Met Eligibility Requirements for the Waiver

HUD did not always (1) ensure that lenders complied with additional underwriting conditions to be eligible for a waiver of its 90-day property-flipping regulation and (2) identify or track loans for 90-day property flips. These weaknesses occurred because HUD lacked adequate procedures and controls to ensure that (1) it performed adequate monitoring and oversight of lenders' compliance with the requirements of the waiver and (2) lenders fully understood the additional underwriting conditions for 90-day property flips and entered accurate information into HUD's FHA Connection.[3] As a result of these deficiencies, the risk to FHA's Mutual Mortgage Insurance Fund increased by more than $2.5 million. Further, HUD lacked assurance of the accuracy of the property-flipping data, which provided the basis for its decision to extend the waiver through 2014. We estimate that over the next year, if HUD does not implement our recommendations, the potential risk to the FHA Mutual Mortgage Insurance Fund will be nearly $274[4] million for properties not meeting eligibility requirements for a waiver of HUD's property-flipping regulation.

HUD Did Not Always Ensure That Lenders Met of the Conditions of the Waiver

HUD determined that it insured 69,196 loans for 90-day property flips during the period February 1, 2010, through December 31, 2012. Of the 69,196 loans, HUD reviewed 2,385 loan files. We statistically selected 95 of the 2,385[5] loans to determine whether the lenders complied with the additional underwriting requirements of HUD's property-flipping waiver. Of the 95 loans selected, only 53 of the loans were subject to the requirements of the waiver.[6] For the 53 loans, 17 (32 percent) contained 1 or more of the following material underwriting deficiencies that were not identified by HUD:

- 12 loan files were missing the required property inspection report,
- 11 loan files were missing evidence of a second appraisal or documentation that supported the increase in property value, and
- 1 loan file did not contain evidence that required repairs for structural or health and safety concerns had been completed before the loan closed.

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[3] FHA Connection is an Internet-based system that allows FHA-approved lenders to have real-time access to several of FHA's systems over HUD's Internet system for the purpose of originating and servicing FHA loans.

[4] Our methodology for this estimate is explained in the Property Flips Identified by HUD subsection of the Scope and Methodology of this audit report.

[5] The universe was reduced to 2,331 for sampling purposes. See the Scope and Methodology of this audit report.

[6] For the remaining 42 loans, 30 were for properties that were permitted to be resold within 90 days in accordance with HUD Mortgagee Letter 2006-14 and 12 were for properties that had ***not*** been resold within 90 days.

Further, HUD did not always maintain support to show that the following material deficiencies identified during the postendorsement technical review for 6 of the 53 loans (11 percent) had been mitigated:

- 6 loan files were missing the required property inspection, and
- 3 loan files were missing evidence of a second appraisal or documentation that supported the increase in property value.

The table in appendix D of this report shows the loans with the deficiencies cited above.

<u>HUD's Removal of System Controls Allowed Lenders To Insure Ineligible Loans</u>

Before the waiver, only an exempt entity[7] could sell a property within 90 days of acquisition. In this instance, the lender would contact HUD's Homeownership Center for the loan's flip status[8] in HUD FHA Connection to be overridden so that the loan could be processed for endorsement. However, after the implementation of the waiver, all loans for 90-day property flips could be processed through the system without requiring a manual override from HUD. Therefore, HUD relied on the lenders to (1) determine whether a loan for a property that had been resold within 90 days was eligible for FHA insurance and (2) correctly enter the associated property information into the system.

We selected 160 loans from 67 lenders totaling more than $26 million, which were identified by HUD as loans for flipped properties that had been insured by FHA since the effective date of the waiver. Of the 160 loans, only 89 were 90-day property flips and subject to the requirements of the waiver.[9] Of the 89 loans, 22 (25 percent) were not eligible for FHA insurance because they did not meet the requirements for the waiver.[10] The following table shows the number of loans and the material underwriting deficiencies identified.

Material deficiencies	Total
Missing second appraisal	9
Lack of documentation for required repairs	9
Property inspection not ordered	7
Total material deficiencies	25

Based on the results of our review, we estimate that over the next year, if HUD does not implement our recommendations, the potential loss to the FHA Mutual

[7] Mortgagee Letter 2006-14 defines the entities that are exempt from HUD's property-flipping regulation.
[8] The flip status category 1 indicator identifies loans that were 90-day flips.
[9] For the remaining 71 loans, 52 loans were for properties that were permitted to be resold within 90 days, and 19 loans were for properties that had ***not*** been resold within 90 days.
[10] Three of the twenty-two loans contained more than one material deficiency.

Mortgage Insurance Fund will be nearly $274 million for properties not meeting the eligibility requirements for a waiver of HUD's property-flipping regulation.

In addition, contrary to HUD's requirements,[11] lenders for 32[12] of the 89 loans (1) did not always enter the property's first appraisal, (2) improperly entered a property's second appraisal, or (3) charged borrowers for 2 appraisals.[13]

The table in appendix E of this report shows the loans with the deficiencies cited above.

HUD's FHA Connection System Did Not Always Identify or Track Loans for 90-Day Property Flips

HUD did not always identify or properly track 90-day property flips. HUD's list of property flips included at least 113 (42 + 71)[14] loans that were not subject to the requirements of the waiver. It also did not differentiate between the loans for properties that were (1) allowed to be resold within 90 days and (2) eligible for FHA insurance because of the waiver.

Using HUD's Single Family Data Warehouse,[15] we identified an additional 35,940 loans that appeared to have been resold within 90 days with an increased value of more than 20 percent. These loans were not (1) included in HUD's listing of loans that it had endorsed since the implementation of the waiver and (2) identified in HUD's system[16] as property flipped loans.

We reviewed a sample of 70 of the 35,940 loans to determine whether the loans were for flipped properties that should have required additional underwriting conditions to be eligible for FHA insurance.[17] Of those 70 loans, HUD did not properly identify 19 (27 percent), valued at more than $3 million, for properties that had been resold within 90 days for more than 20 percent above the previous sellers' acquisition cost. In projecting the results of our sample to the universe, we estimate that HUD did not properly identify nearly 6,800 properties that had been resold within 90 days of acquisition with an increased sale price of more than 20 percent.

[11] Federal Register Notice, FR-6149-N-23
[12] Nine of the thirty-two loans contained more than one deficiency.
[13] Federal Register Notice, FR-5397-N-01
[14] See footnote 6 and footnote 9
[15] Single Family Data Warehouse is a large and extensive collection of database tables organized and dedicated to support the analysis, verification and publication of Single Family Housing data.
[16] Lenders enter data into HUD's FHA Connection, which is uploaded into HUD's Single Family Data Warehouse. Therefore, data for FHA Connection's flip status indicator 1 populated HUD's Single Family Data Warehouse flip status category 1 indicator.
[17] The universe contained 4,275 properties with executed sales contracts before the implementation of the first waiver.

According to HUD's Office of Program Development, data on 90-day property flips were retrieved from HUD's Single Family Data Warehouse System and used to (1) analyze the effectiveness of the waiver and (2) support the Office of Single Family Housing's decision to extend the waiver. However, due to HUD's inability to accurately track and identify loans for 90-day property flips, HUD could not adequately monitor lenders for compliance with the additional underwriting requirements of the waiver and accurately determine the effectiveness of the waiver to support its decision to extend the waiver through 2014.

HUD Lacked Adequate Procedures and Controls

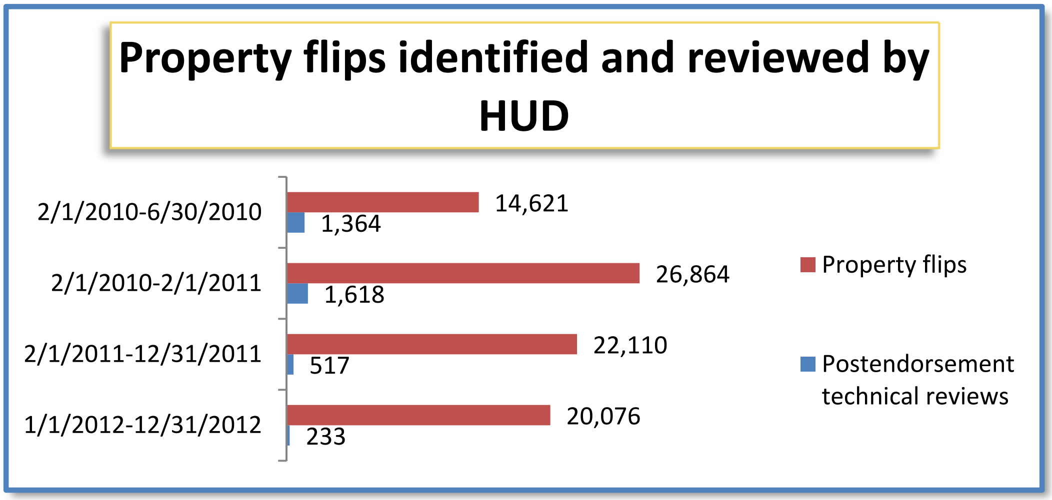
The weaknesses described above occurred because HUD lacked adequate procedures and controls to ensure that (1) it performed adequate monitoring and oversight of lenders for compliance with the requirements of the waiver and (2) lenders fully understood the additional underwriting conditions for 90-day property flips and (3) lenders entered accurate information into FHA Connection.

HUD's property-flipping waiver implemented eligibility conditions to mitigate the risks associated with 90-day property flips. HUD's Assessment for Exemption From Compliance With FHA's Regulation on Property Flips in Calendar Year 2010, stated that flipped property loans would be targeted for a postendorsement technical review. However, according to HUD, these loans were targeted for a postendorsement technical review for only the first 5 months[18] of the waiver. After that, the loans were selected for review using a risk-based approach. Further, according to HUD's assessment, nearly 48 percent of the loans for property flips received an unacceptable valuation rating, which was a substantially higher percentage than for other loans. The majority of the unacceptable valuation ratings were the result of documentation compliance issues, such as missing inspection reports, second appraisals, and termite reports.

HUD's assessment also determined that (1) the requirement for the documentation was new to lenders and FHA and (2) lenders interpreted the controls inconsistently or incorrectly. However, HUD did not provide additional documentation to support that it performed an assessment of lenders' compliance each time it extended the waiver. Instead, it performed fewer postendorsement technical reviews of flipped property loans.

The figure below shows the number of loans that HUD identified as being for flipped properties compared to the number of loans HUD reviewed during its initial 5-month assessment and later waiver extensions.[19]

[18] From February 1, 2010 through June 30, 2010.
[19] HUD's universe contained 146 loans for properties with executed sales contracts before the waiver.



Further, in performing postendorsement technical reviews, HUD's postendorsement technical reviewers or contractors[20] (1) accepted incorrect or inadequate explanations from lenders or (2) did not request required documentation. For instance, if a property inspection identified required repairs for health and safety violations, HUD indicated that those repairs were considered mitigated if the repairs were not identified in the appraisal report. However, the waiver explicitly required a final inspection to determine whether the repairs had been satisfactorily completed.

In addition, when we contacted the lenders to obtain the missing required documentation, we were informed by several lenders that the documents were not available because they (1) were not aware that the documents were required or (2) did not fully understand the additional requirements for 90-day property flips to be eligible for FHA insurance. For instance, one lender stated that the property flipping waiver was unclear about whether an appraiser could conduct the property inspection. Further, because it is customary for a borrower to have the inspection report, it is difficult for the lender to obtain the report from the borrower before the loan closing.

Further, HUD's removal of its system controls allowed lenders to endorse loans for 90-day property flips that would have normally been rejected. However, HUD did not have adequate procedures and controls in place to ensure that lenders (1) complied with the requirements of the waiver and (2) correctly identified loans that were for 90-day property flips.

From our samples of 95 loans that were reviewed by HUD under a postendorsement technical review and 160 loans that we reviewed for lender compliance, a total of 31 loans (12 + 19)[21] did not have to comply with the requirements of the waiver because these loans were for properties that had ***not***

[20] On October 4, 2010, HUD discontinued using contractors to perform postendorsement technical reviews.
[21] See footnote 6 and footnote 9

been resold within 90 days. However, these loans were identified by HUD as loans for flipped properties.

In addition, lenders did not always use the correct resale date when entering information into HUD's FHA Connection. The lenders used the date on which the buyers signed the sales contract as the resale date in accordance with Mortgagee Letter 2006-14 and HUD Handbook 4155.2, paragraph 4.7.e, which states that the resale date is the date of execution of the sales contract by the buyer. However, 24 CFR 203.37a(b)(1) states that the resale date is the date of execution of the sales contract that would result in the FHA mortgage insurance.

We sought clarification from HUD regarding a property's resale date. HUD's senior housing program manager for its Processing and Underwriting Division stated that the resale date or current sale contract date is the date on which the borrower initiated a contract of sale on the subject property. However, HUD's senior policy advisor for the Office of Single Family Housing, Home Mortgage Insurance Division, stated that FHA views the execution date of the sales contract as the date on which the buyer and seller signed the contract. After consulting with the Office of General Counsel, HUD's Office of Single Family Housing confirmed that the resale date, which is the execution date of a real estate sales contract, is the date on which both the buyer and the seller signed the contract, making it enforceable.

Further, lenders relied on data such as acquisition cost and the prior sale date identified in the appraisal reports. However, the data were not always accurate.

Conclusion

HUD lacked adequate procedures and controls to ensure that (1) it performed adequate monitoring and oversight of lenders for compliance with the requirements of the waiver and (2) lenders fully understood the additional underwriting conditions for 90-day property flips and entered accurate information into HUD's system. As a result, the risk to FHA's Mutual Mortgage Insurance Fund increased by more than $2.5 million. Further, HUD lacked assurance of the accuracy of the property-flipping data, which provided the basis for its decision to extend the waiver through 2014.

We estimate that over the next year, if HUD does not implement our recommendations, the potential risk to the FHA Mutual Mortgage Insurance Fund would be nearly $274 million for properties not meeting the eligibility requirements for a waiver of HUD's property-flipping regulation.

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing to require the lenders to

1A. Support that the loans cited for postendorsement technical reviews by HUD were eligible for FHA insurance or require the lenders to indemnify HUD for any future losses on the 12 loans[22] with an estimated loss of $1,047,314,[23] based on the loss severity rate of 54 percent of the total unpaid principal balance of $1,939,471 as of June 1, 2014.

1B. Indemnify HUD for any future losses on the 16 loans[24] with an estimated loss of $1,487,921,[25] based on the loss severity rate of 54 percent of the total unpaid principal balance of $2,755,409 as of June 1, 2014.

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing

1C. Discontinue the waiver for 90-day property flips upon its termination on December 31, 2014, or strengthen controls over HUD's property-flipping waiver requirements. Such controls should include ***but not be limited to*** (1) improving its existing policies, procedures, and reporting system to ensure that it properly identifies and reviews property flips; (2) establishing consistent standards for the documentation lenders are required to provide to HUD's Homeownership Centers and maintain in the FHA case binders or lenders' files; (3) providing training to HUD reviewers for reviewing flipped properties; and (4) monitoring lenders' data entries in FHA Connection to ensure the accuracy and completeness of data. The discontinuance or strengthened controls should result in $273,881,986 in funds to be put to better use.

1D. Issue clarification on the criteria for determining a loan's sales contract date and a property's resale date to ensure consistent and accurate application by lenders.

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[22] The 23 unsupported loans consist of the 17 loans that contained one or more deficiency not identified by HUD plus the six loans for which HUD did not maintain support that the material deficiencies had been mitigated. Of the 23 unsupported loans cited in this report, only 14 were active in HUD's Single Family Data Warehouse as of June 1, 2014; the remaining 9 were terminated loans. Of the 14 active loans, (1) the lender signed an indemnification agreement for FHA case number 137-5624402 during our audit, and (2) FHA case number 197-5413909, which was reviewed in both samples, is included in recommendation 1B. Therefore, our recommendation is for the remaining 12 loans.

[23] See Appendix F

[24] Of the 22 ineligible loans cited in this report, only 16 were active in HUD's Single Family Data Warehouse as of June 1, 2014; the remaining 6 were terminated loans.

[25] See Appendix F

SCOPE AND METHODOLOGY

We performed our audit work from November 2012 through March 2014 at our offices located in Chicago, IL, Columbus, OH, and Detroit, MI. The audit covered the period February 1, 2010, through December 31, 2012, and was adjusted as necessary. To accomplish our objective, we

- Reviewed relevant background information, applicable mortgagee letters, HUD handbooks, the Code of Federal Regulations, Federal Register notices, HUD press releases, FHA's Post Endorsement Technical Review Desk Guide (effective October 2010), HUD's Single Family Housing Enterprise Data Warehouse User's Guide, and HUD's Web site;
- Downloaded and analyzed loan-level data from HUD's Single Family Housing Enterprise Data Warehouse related to property flips;
- Reviewed loan-level data from HUD's Neighborhood Watch Early Warning System;[26]
- Selected and reviewed statistical samples of loans related to property flipping;
- Reviewed Accurint[27] information for the selected loans; and
- Communicated with HUD staff and lenders.

Statistical Samples

HUD's Postendorsement Technical Reviews

Using HUD's Single Family Data Warehouse system as of April 1, 2013, we identified 69,196 loans endorsed between February 1, 2010, and December 31, 2012, which were identified by HUD as property flips. Of these loans, 2,385 underwent a postendorsement technical review performed by HUD's Processing and Underwriting Division. To control for accuracy, 37 loans that exceeded $450,000 in value were excluded as outliers.[28] Of the 2,331[29] loans reviewed by HUD, we statistically selected 95 totaling more than $15.9 million to assess HUD's oversight of property flipping.

Loans were stratified by the unpaid balance to control for dollar variance amounts, which provided a tighter, more accurate projection. These strata were developed by ranking loans in order of unpaid balance and dividing them into six cost tiers by percentile. Table 1 shows the stratification scheme for sampling the current population proportionately.

[26] Neighborhood Watch is a Web-based software application that displays loan performance data for lenders and appraisers using FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.
[27] The Accurint database is an online resource that provides information on legal and public records.
[28] An outlier is an element of a data set that distinctly stands out from the rest of the data. Therefore, we identified the outliers and removed them from the data before performing our statistical analysis.
[29] 2,385 – 37 – 17 = 2,331. The 17 represents loans with sales contract dates prior to the effective date of the waiver.

Table 1: Sample design				
Strata	**Loan balance > or =**	**Sample size**	**Population count**	**Sampling weight**
Other 0-10%	$0	8	5,810	726.25
Other 10-30%	$79,850	16	12,061	753.81
Other 30-50%	$118,570	14	11,042	788.71
Other 50-70%	$154,321	12	9,002	750.17
Other 70-90%	$203,912	10	7,715	771.50
Other 90-100%	$289,832	5	3,753	750.60
Top 9 0-10%	$0	9	1,901	211.22
Top 9 10-30%	$79,850	19	3,803	200.16
Top 9 30-50%	$118,570	19	3,803	200.16
Top 9 50-70%	$154,321	19	3,803	200.16
Top 9 70-90%	$203,912	19	3,802	200.11
Top 9 90-100%	$289,832	10	1,902	190.20
Total	**N/A**	**160**	**68,397**	**N/A**

As shown in table 2, flipped properties tend to be concentrated in States where real estate prices have undergone radical change. Volatility in real estate prices was managed by indexing States according to the average decline in real estate prices between the first quarter of 2008 and the third quarter of 2010. Sampling units were further sorted within each cost stratum by the degree of decline in their State.

Table 2: Concentration of flips	
State price changes	**flips**
3% to 10% growth	5
- 3% to + 3% growth	379
>3% to 6% decline	256
>6% to 12% decline	308
>12% to 20% decline	289
>20% decline	1,111
Change in home prices, quarter 1 of 2008 to quarter 3 of 2010	

We modeled the performance of the stratified sample by simulating how well it detected various error rates for various sample sizes. Replicated sampling was used to test the performance of the sample design in scenarios in which the rate of error ranged from 5 to 50 percent and sample sizes varied from 70 to 105 samples. The simulation results were compared with the actual dollar amount in the underlying error scenario to verify the accuracy of results using these methods. The recommended sample size of 95 was found to be effective in preventing errors, During the audit, we tested a statistical sample of 95 loans, of which only 53 were property flip transactions. Of the 53 loans, we found that HUD's Processing and Underwriting Division did not properly identify or mitigate at least 1 material deficiency for 23 loans (43 percent). Based on a stratified sample, we can say, with a one-sided confidence interval of 95 percent that at least 15.6 percent, or 365, of the 2,331 loans had similar undetected problems or resolution issues in flipped property loans during HUD's postendorsement technical reviews.

Property Flips Identified by HUD

Of the universe of loans identified by HUD as property flips, we statistically selected 160 loans totaling more than $26 million to review for lenders' compliance with HUD's property-flipping waiver requirements and data integrity. Loans were stratified in order of their unpaid balance and divided into six cost tiers by percentile within this rank. The sample count for each stratum was proportionate to its size within the population of loans issued by the banks.

As shown in table 3, flips tended to be concentrated in States where real estate prices had undergone radical change. Volatility in real estate prices was controlled by indexing States according to the average decline in real estate prices between the first quarter of 2008 and the third quarter of 2010. Sampling units were further sorted within each cost stratum by the degree of decline in their State, and the units in each stratum were systematically sampled.

Table 3: Concentration of flips by price growth decline

Price change	Flips
3% to 10% growth	47
- 3% to + 3% growth	1,786
>3% to 6% decline	1,179
>6% to 12% decline	1,556
>12% to 20% decline	2,204
>20% decline'	12,242

Change in home prices, quarter 1 of 2008 to quarter 3 of 2010

A sample size of 95 was chosen. Computer-replicated sampling (audit simulations) was used to test the performance of the sample design in scenarios in which the rate of error ranged from 5 to 50 percent of the universe and sample size ranged from 70 to 105 samples. The results were compared with the actual dollar amounts to verify the accuracy of the results using these methods.

The minimum advisable sample design noted above was expanded to include loans from additional banks. A supplemental sample of 65 loans was drawn from the supplemental parts of the universe using the same stratification scheme and selection method that was used for the primary sample. For a total sample size of 160 loans, see table 1. If the minimum sample design was applied to the whole universe, about 65 case binders would be pulled from the records of the other banks.

At least 7.23 percent, or 4,933, of the loans were legitimate flips but had one of the problems identified with eligibility for FHA loans on properties that had been flipped. Based on a stratified, random sample, with a one-side confidence interval of 95 percent, this constitutes at least $798.8 million FHA loan dollars that were not protected from risk by at least one of the eligibility requirements audited.

Our calculations are shown below:

(12.2389% - 1.6552 X 3.0271%) x N = 7.23% x N = 4,933 loans
(19265 - 1.6552 X 4567.7) x N = 11705 x N = $798,800,000 FHA loan dollars

Prorating this amount from 35 months to a 1-year period yields an estimated $274 million that will not be protected from risk over a single year. Our calculation is shown below:

12/35 x $798.8 million ≈ $12/35 x $798,822,458 ≈ $273,881,986 FHA loan dollars

Potential Flips Identified

Using a property's sales contract date and its prior sale date, we identified 35,940 properties with loan values totaling more than $5.3 billion that were sold within 90 days of acquisition during our audit period but not identified as property flips in HUD's system. We statistically selected 70 loans totaling more than $11 million to determine whether these loans were 90-day property flips and HUD's effectiveness in identifying mortgages on flipped properties.

The universe was comprised of properties that were sold within 90 days of acquisition and not designated as flips in HUD's Single Family Data Warehouse system. The methodology was the same used for the audit's other samples and accounted for variations in price fluctuation by State. A sample size of 70 was calculated using the classical proportion estimating formula with traditional levels of significance and confidence limits. Of those 70 loans, HUD did not properly identify 19 (27 percent), valued at more than $3 million, for properties that had been resold within 90 days for more than 20 percent above the previous sellers' acquisition cost. In projecting the results of our sample to the universe, we estimate, with a one-sided confidence interval of 95 percent, that HUD did not properly identify nearly 6,800 properties that had been resold within 90 days of acquisition with an increased sale price of more than 20 percent.

We relied on information maintained in HUD's Neighborhood Watch and Single Family Data Warehouse systems for informational and sampling purposes only. We also relied on data maintained in the lenders' systems, such as electronic loan files. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes. The HUD system data for sampled items were validated by reviewing documents supplied by the sampled lenders. The audit results were based on our review of electronic and supporting hardcopy documentation maintained by the lenders.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- HUD lacked adequate procedures and controls to (1) ensure that lenders complied with the additional underwriting conditions to be eligible for a waiver of its 90-day property-flipping regulation and (2) identify or track loans for 90-day property flips (see finding).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A		$1,047,314	
1B	$1,487,921		
1C			$273,881,986
Totals	$1,487,921	$1,047,314	$273,881,986

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, if HUD implements our recommendation 1C, it will reduce the risk to the FHA insurance fund for loans that do not meet HUD's underwriting requirements under the property-flipping waiver. Our estimate reflects only the initial year of this benefit. The $798.8 million amount identified based on the audit sample, which covered a 35-month period, was proportionally adjusted to reflect the estimated savings for a 12-month period. Prorating this amount from 35 months to a 1-year period yields an estimated nearly $274 million that is not protected from risk over a single year. Our calculation is shown below:

12-month estimate: 12/35 months x $798.8 million = **$273,881,986**

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

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

OFFICE OF HOUSING

MEMORANDUM FOR: Kelly Anderson, Regional Inspector General for Audit, Chicago, 5AGA

FROM: Sandra L Sampedro 9/24/2014 for Kathleen A. Zadareky, Deputy Assistant Secretary for Single Family Housing, HU

SUBJECT: Discussion Draft – HUD's Oversight of Property Flipping

The Office of Inspector General (OIG) audited the Department of Housing and Urban Development's Property Flipping Waiver Requirements. The objective of the audit was to determine whether HUD had adequate oversight of its property flipping waiver requirements.

Comment 1

The Office of Single Family Housing (Single Family) will review and evaluate the current policies and procedures concerning its property flipping waiver requirements.

"Property flipping" refers to the practice in which a property recently acquired is resold for a considerable profit with an artificially inflated value, often as the result of a lender's collusion with an appraiser. Most property flipping occurs within a matter of days after acquisition, and usually with only minor cosmetic improvements, if any, to the property. In an effort to prevent this predatory lending practice with respect to FHA-insured mortgages, HUD issued a final rule in 2003 (24 CFR 203.37a) providing that FHA will not insure a mortgage if the contract of sale for the purchase of the property that secures the mortgage is executed within 90 days of the prior acquisition by the seller, and the seller does not meet any of the rule's exemptions.

Comment 2

Single Family's response to the audit recommendations are as follows:

Single Family is reassessing the need for a waiver and is not planning on extending it at this time. Due to the short time remaining, the recommended controls and clarifications could not be implemented prior to the December 31, 2014, expiration. This would also negate any potential savings such controls would have offered.

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OIG's Evaluation of Auditee Comments

Comment 1 We acknowledge the Office of Single Family Housing's plan to review and evaluate the current policies and procedures concerning its property-flipping waiver requirements.

Comment 2 The Office of Single Family Housing stated that it is reassessing the need for the waiver and is not planning on extending the waiver at this time. Further, with the waiver expiring on December 31, 2014, the Office of Single Family Housing stated that it could not implement OIG's recommended controls and clarifications.

We commend the Office of Single Family Housing for reassessing the need for the property-flipping waiver and acknowledge its plan of not extending the waiver at this time. However, its reassessment and plan do not constitute final resolution of OIG's recommendations, including recommendations 1C through 1E of the discussion draft audit report. The Office of Single Family Housing has not provided a firm commitment to discontinue the property-flipping waiver. Further, the discontinuance of the waiver would serve as a form of internal control. We combined recommendation 1E with recommendation 1C of the discussion draft audit report, which is now recommendation 1C of this audit report.

According to the United States Government Accountability Office's (GAO) Standards for Internal Control in the Federal Government, internal control is a process used by management to help an entity achieve its objectives. For instance, one benefit of internal control is that it helps reduce risks affecting the achievement of an entity's objectives. With FHA's goal of helping to stabilize neighborhoods and communities and the potential of a property being resold for a considerable profit with an artificially inflated value, it is important for the Office of Single Family Housing to implement adequate controls to reduce the risk to the Mutual Mortgage Insurance Fund.

Although we acknowledge the limited time remaining before the current waiver extension expires, we disagree with HUD's statement that this would negate any potential savings OIG's recommended controls would have offered. Since it is a possibility that the Office of Single Family Housing could extend or implement the waiver in the future, we recommend that HUD reconsider implementing our recommendations in this audit report. Therefore, the amount cited for funds to be put to better use, which is based on the inadequate controls that allowed lenders to underwrite ineligible FHA-insured loans, will also remain in the report.

Appendix C

CRITERIA

Regulations at 24 CFR 203.37a(b) state that the eligibility of a property for a mortgage insured by FHA is dependent on the time that has elapsed between the date on which the seller acquired the property (based upon the date of settlement) and the date of execution of the sales contract that will result in the FHA mortgage insurance (the resale date). The lender must obtain documentation verifying compliance with the time restrictions described in this paragraph and must submit this documentation to HUD as part of the application for mortgage insurance in accordance with subsection 203.255(b). Further, if the resale date is 90 days or fewer following the date of acquisition by the seller, the property is not eligible for a mortgage to be insured by FHA.

Regulations at 24 CFR 203.37a(d) state that failure of a lender to comply with the requirements of this section may result in HUD's requesting indemnification of the mortgage loan or seeking other appropriate remedies under 24 CFR Part 25.

HUD Handbook 4000.2, REV-3, section 1-7, states that property flipping is a practice in which recently acquired property is resold for a considerable profit with an artificially inflated value, often abetted by a lender's collusion with the appraiser. A property acquired by the seller is not eligible for a mortgage to be insured by FHA for the buyer unless the seller has owned that property for at least 90 days. If a property is resold 90 days or fewer following the date of acquisition by the seller, the property is not eligible for a mortgage insured by FHA. FHA defines the seller's date of acquisition as the date of settlement on the seller's purchase of that property. The resale date is the date of execution of the sales contract by a buyer intending to finance the property with an FHA-insured loan.

HUD Handbook 4150.2, CHG-1, appendix D, D-1: Uniform Residential Appraisal Report, provides that section 2 ("Contract" section) of the appraisal report must be completed when the appraisal assignment involves a purchase transaction; otherwise, "N/A," for not applicable, should be entered. FHA requires that the appraiser be provided a complete copy of the ratified sales contract for the subject property, including all addenda. It provides the agreed-upon contract price (accepted offer), date of sale, and all financial terms implicit in the offer. If unable to obtain this information, the appraiser is to state what efforts were made to obtain it. This handbook also provides that the

- Date of contract is the date when all parties have agreed to the terms of and signed the contract (section 2 – contract) and
- Date of sale or time is the month and year of settlement. Showing the contract date and settled date is also acceptable (section 6 – sales comparison analysis).

Mortgagee Letter 2006-14 states that categories of properties exempted from property-flipping time restrictions include

- Sales by HUD of its real-estate owned properties.
- Sales by other United States Government agencies of single-family properties under programs operated by these agencies.
- Sales of properties by nonprofits approved to purchase HUD-owned single-family properties at a discount with resale restrictions.
- Sales of properties that are acquired by the sellers by inheritance.
- Sales of properties purchased by employers or relocation agencies in connection with relocations of employees.
- Sales of properties by State and federally chartered financial institutions and government-sponsored enterprises.
- Sales of properties by local and State government agencies.

Upon FHA's announcement of eligibility in a notice, sales of properties located in areas designated by the President as Federal disaster areas will be exempt from the restrictions of the property-flipping rule. The notice will specify how long the exception will be in effect and the specific disaster area affected.

Federal Register Notice 28632, volume 75, number 98, dated May 21, 2010, provides that for all sales contracts executed on or after February 1, 2010, FHA has waived its regulation that prohibits the use of FHA financing to purchase properties that are being resold within 90 days of acquisition. This notice was effective from February 1, 2010, through February 1, 2011.

Federal Register Notice 6149, volume 76, number 23, dated February 3, 2011, provides that for all sales contracts executed on or after February 1, 2010, FHA is extending the availability of the temporary waiver of its regulation that prohibits the use of FHA financing to purchase single-family properties that are being resold within 90 days of acquisition until December 31, 2011. Further, if the lender has ordered a second appraisal to document the increase in value, it must not use this appraisal for case processing and must not enter it into FHA Connection. This notice was effective from February 1 through December 31, 2011.

Federal Register Notice 81363, volume 76, number 249, dated December 28, 2011, provides that for all sales contracts executed on or after February 1, 2010, FHA is extending the availability of the temporary waiver of its regulation that prohibits the use of FHA financing to purchase single-family properties that are being resold within 90 days of acquisition until December 31, 2012. This notice was effective from January 1 through December 31, 2012.

Federal Register Notice 71099, volume 77, number 230, dated November 29, 2012, provides that for all sales contracts executed on or after February 1, 2010, FHA is extending the availability of the temporary waiver of its regulation that prohibits the use of FHA financing to purchase single-family properties that are being resold within 90 days of acquisition until December 31, 2014. This notice was effective from January 1, 2013, through December 31, 2014.

HUD's Post Endorsement Technical Review Desk Guide, dated October 2010, chapter 1, states that the postendorsement technical review process is one of several FHA processes used to help monitor and mitigate risk to the FHA insurance fund by conducting technical reviews on a selection of postendorsement loans to ensure lender compliance with FHA credit and valuation policies and procedures. These reviews help to identify areas of lender origination noncompliance, permitting FHA to require corrective actions to mitigate risk, including indemnification and referral to the Mortgagee Review Board. In addition, these reviews assist FHA management in determining whether policy changes are warranted or additional industry guidance is needed.

Appendix D

SCHEDULE OF POSTENDORSEMENT TECHNICAL REVIEW DEFICIENCIES

FHA case number	HUD deficiency not identified	File lacking documentation showing that issue was resolved	Lacked inspection	No support showing that health and safety repairs were made	Lacked second appraisal
023-4037895		X	X		
042-9307714		X	X		
044-4721335	X		X		X
045-7785116	X		X		X
048-5805973	X				X
048-5886189	X				X
048-6930885	X		X		
091-4828276	X				X
093-6920208	X		X		X
094-6447291	X		X		X
105-5797625	X		X		
137-5624402	X		X		
137-5795343	X		X		
156-0269188	X		X		
197-4874651	X		X		X
197-4897370	X				X
197-5413909	X			X	
292-5716802	X		X		X
421-4786604		X	X		X
446-0124796		X	X		
461-5058377		X	X		X
541-9195137		X	X		X
548-4872196	X		X		X
	17	6	18	1	14

Appendix E

SCHEDULE OF LENDER COMPLIANCE DEFICIENCIES

FHA case number	Lacked inspection	No support showing that health and safety repairs were made	Lacked second appraisal	Buyer charged for two appraisals	Second appraisal logged into FHA Connection	First appraisal not logged into FHA Connection
022-2330427		X		X		
022-2365330				X		
023-4815063	X					
023-4831696		X				
023-4837451					X	
042-8979143			X			
042-9420661		X		X	X	
043-8481627			X			
043-8661466				X	X	X
043-8665734					X	
043-8678353					X	X
043-8793295		X			X	
044-4861839			X			
045-7497691					X	
045-7608960			X			
045-7646436					X	
048-6079821			X			
048-6483728		X			X	X
048-6515084					X	
048-6659714	X				X	X
048-6917264					X	X
048-7086619					X	
048-7200611					X	

SCHEDULE OF LENDER COMPLIANCE DEFICIENCES (CONCLUDED)

FHA case number	Lacked inspection	No support showing that health and safety repairs were made	Lacked second appraisal	Buyer charged for two appraisals	Second appraisal logged into FHA Connection	First appraisal not logged into FHA Connection
052-6856159					X	
052-6878279					X	
093-7442829					X	
095-2288478					X	
095-2298236					X	X
105-6103760	X					
121-2960481					X	
137-6709737	X				X	
161-2998265					X	X
197-5378258					X	
197-5413909		X				
197-5647746		X			X	X
197-5825809		X				
197-5955144		X			X	
221-4752113					X	
222-1907716	X		X			
292-6101998					X	
332-5612183			X			
341-1258298					X	
372-4326504					X	
431-5143212	X		X			
446-0153031	X		X			
521-8475262					X	
	7	9	9	4	30	8

Appendix F

ESTIMATED LOSSES TO HUD FOR MATERIAL DEFICIENCIES

FHA case number	Unpaid principal balance[30]	Estimated loss[31] for recommendation 1A	Estimated loss for recommendation 1B
022-2330427	$110,380		$59,605
023-4815063	106,760		57,650
042-9307714	262,932	$141,983	
042-9420661	181,398		97,955
043-8481627	191,994		103,677
043-8793295	155,036		83,719
045-7608960	153,736		83,017
045-7785116	39,383	21,267	
048-5805973	213,178	115,116	
048-5886189	150,959	81,518	
048-6079821	129,025		69,674
048-6659714	181,916		98,235
091-4828276	137,013	73,987	
093-6920208	88,478	47,778	
094-6447291	87,389	47,190	
105-6103760	81,146		43,819
137-5795343	267,952	144,694	
137-6709737	168,764		91,133
197-4897370	245,865	132,767	
197-5413909	200,199		108,107
197-5825809	238,081		128,564
197-5955144	359,738		194,259
292-5716802	171,647	92,689	
332-5612183	142,476		76,937
431-5143212	206,758		111,649
446-0153031	148,002		79,921
461-5058377	101,812	54,978	
541-9195137	172,863	93,346	
Totals	**$4,694,880**	**$1,047,314**	**$1,487,921**

[30] The unpaid principal balance amounts were drawn from HUD's Single Family Data Warehouse as of June 1, 2014, for the active FHA loans with material deficiencies.

[31] The estimated loss is 54 percent of the unpaid principal balance amounts. The 54 percent is the estimated percentage of loss HUD would incur when the FHA property is foreclosed upon and resold as supported by the HUD Single Family Acquired Asset Management System's case management profit and loss by acquisition as of June 2014.