



# Office of Housing Washington, DC

## Distressed Asset Stabilization Program



**To:** Susan Betts, Acting Deputy Assistant Secretary for Finance and Budget  
Office of Housing, HW

*//signed//*

**From:** Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

**Subject:** HUD Did Not Conduct Rulemaking or Develop Formal Procedures for Its Single-Family Note Sales Program

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the single-family notes sales program.

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 website. 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 913-551-5870.



**Audit Report Number: 2017-KC-0006**  
**Date: July 14, 2017**

## **HUD Did Not Conduct Rulemaking or Develop Formal Procedures for Its Single-Family Note Sales Program**

# Highlights

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## **What We Audited and Why**

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We audited the U.S. Department of Housing and Urban Development's (HUD) rulemaking process for its single family note sales program. We initiated the audit due to the large amount of Federal Housing Administration claims paid on note sales and because our office has never audited the single-family note sales program. Also, there are public concerns over the creation and administration of the note sales program. This is the first in a series of audits to review the note sales program. Our audit objective was to determine whether HUD conducted rulemaking for its single-family note sales program.

## **What We Found**

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HUD did not conduct rulemaking or develop formal procedures for its single-family note sales program. HUD did issue an advance notice of proposed rulemaking in 2006 to solicit comments on its note sales program. However, it did not finalize the comment process or prepare the program for a final rule. Additionally, HUD did not develop formal guidance or procedures for its note sales program.

## **What We Recommend**

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We recommend that the Acting Deputy Assistant Secretary of Finance and Budget and (1) complete the rulemaking process for its single-family note sales program and (2) develop and implement formal procedures and guidance for the note sales program.

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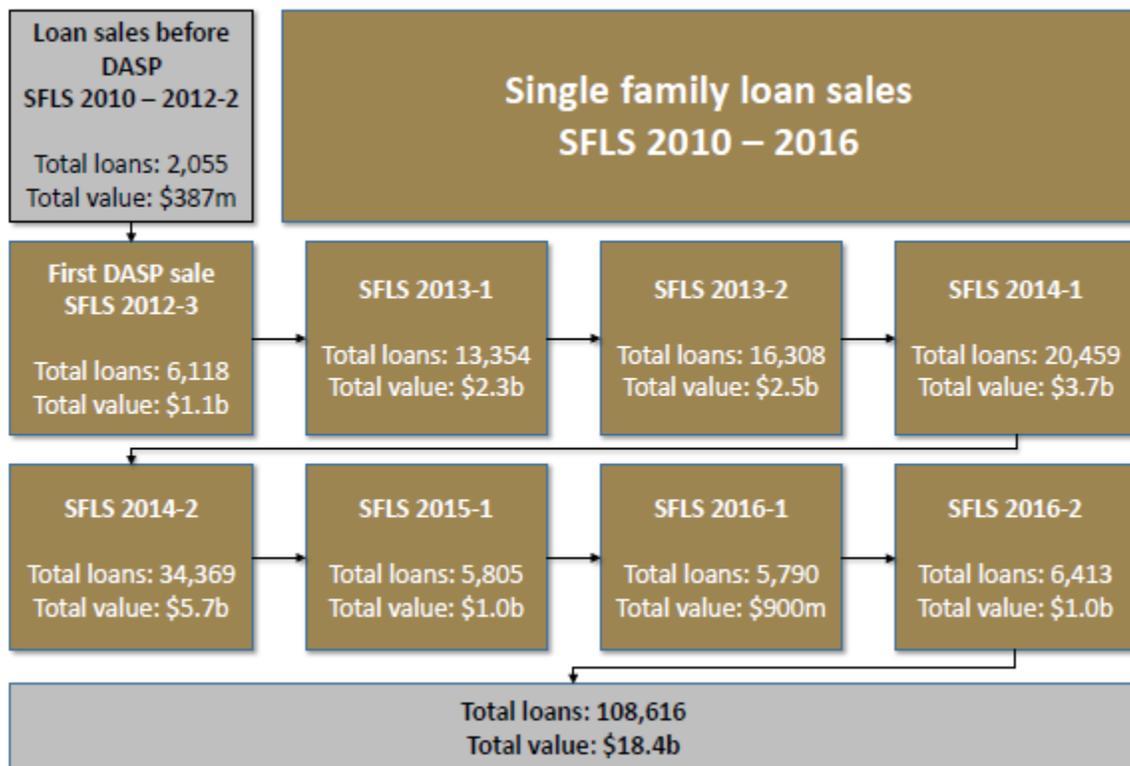
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# Background and Objective

The U.S. Department of Housing and Urban Development’s (HUD) Office of Housing conducts single-family mortgage note sales under section 204(g) of the National Housing Act. The distressed notes are sold through the Office of Finance and Budget’s Office of Asset Sales. HUD has referred to its single-family note sales program by different titles. In 2002, HUD referred to its initial note sales program as the Accelerated Claims Disposition Demonstration program. From 2002 to 2005, HUD conducted four notes sales under the demonstration program. After a nearly 5-year pause, HUD continued the note sales program referring to it as the Single Family Loan Sales (SFLS) program. HUD held three note sales in 2012. The first two sales were under the Loan Sales program, and with the third note sale, the name of the program was changed to the Distressed Asset Stabilization Program (DASP). DASP accepts assignment of eligible, defaulted single-family mortgage loans in exchange for claim payment and then sells them in a variety of pooled note sales. The Federal Housing Administration (FHA) insurance on the mortgages terminates when the pooled notes are sold to investors.

The chart below illustrates the progression of the single-family note sales from 2010 to 2016. The chart shows that the program expanded from 2,055 notes with approximately \$387 million in unpaid principal balances before DASP to more than 108,000 notes with approximately \$18.4 billion in unpaid principal balances.



According to the Administrative Procedure Act, agencies must follow an open public process when they issue rules. This process includes publishing a statement of rulemaking authority in the Federal Register for all proposed and final rules. The proposed rule, or notice of proposed rulemaking, is the official document that announces and explains the agency's plan to address a problem or accomplish a goal. Agencies must publish proposed rules in the Federal Register to notify the public and to give citizens an opportunity to submit comments. The proposed rule and the public comments received on it form the basis of the final rule. The Act permits agencies to finalize some rules without first publishing a proposed rule in the Federal Register. This exception is limited to cases in which the agency has "good cause" to find that the notice-and-comment process would be "impracticable, unnecessary, or contrary to the public interest." The agency must state its reasoning for finding good cause in the preamble of the final rule published in the Federal Register.

Our audit objective was to determine whether HUD conducted rulemaking for its single-family note sales program.

# Results of Audit

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## **Finding: HUD Did Not Conduct Rulemaking or Develop Formal Procedures for Its Single-Family Note Sales Program**

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HUD did not conduct rulemaking or develop formal procedures for its single-family note sales program. This condition occurred because HUD officials did not have a formal plan to transition HUD's single-family note sales from a demonstration program to an official HUD program. As a result, public officials, citizens, and industry participants were not given the opportunity to provide comments for a more than \$18 billion program.

### **HUD Did Not Conduct Rulemaking or Develop Formal Procedures**

HUD did not conduct rulemaking or develop formal procedures for its single-family note sales program. In 2006, HUD started but did not complete rulemaking for its note sales program. HUD issued an advance notice of proposed rulemaking to solicit comments on its Accelerated Claim and Asset Disposition program. This was the first title used by HUD in referring to its single-family note sales program, now referred to as the Distressed Asset Stabilization Program (DASP). In that notice, HUD stated, "This notice solicits comments on HUD ACD [Accelerated Claim and Asset Disposition] Demonstration program before HUD issues a proposed rule to codify the requirements for the ACD program." HUD went on in the Background section of the

**Accelerated Claim and Asset Disposition (ACD) Program; Advance Notice of Proposed Rulemaking**

**AGENCY:** Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

**ACTION:** Advance notice of proposed rulemaking.

notice to state, "Before implementing the new ACD disposition process on a nationwide basis, HUD has conducted an ACD Demonstration program involving a group of defaulted mortgages. This has allowed HUD to assess the overall effectiveness of this disposition process. HUD believes that improvements can be made to the program to make it more effective.

Consequently, before proceeding with the regulatory codification of the ACD program, HUD is soliciting comments from all interested parties, especially those who participated or declined to participate in the Demonstration program, on possible improvements to the program." HUD continued, "When codified, the ACD program will become a permanent part of HUD's single family mortgage insurance programs. The proposed rule would also revise 24 CFR [Code of Federal Regulations] part 291, which governs the disposition of HUD-acquired single family property, to incorporate the policies and procedures for the sale of loans assigned to HUD under the ACD program." However, HUD did not finalize the comment process or prepare the program for a final rule.

We believe DASP is a substantive rule, which would be subject to rulemaking requirements under 24 CFR Part 10, which extends Administrative Procedure Act rulemaking requirements to

HUD programs regarding loans and public property. During the pre- note and post- note sale process, there are restrictions on the pooled loans, notification requirements to borrowers, and specific participation requirements of nonprofits and local governments in a direct sales program. These factors strongly suggest that this is more than a simple contractual relationship and may have impacts beyond the actual purchaser of the assigned mortgages. We have included the complete criteria requirements in appendix B.

HUD also did not develop formal guidance or procedures for its note sales program. In 2010, HUD published a “Notice of Single Family Loan Sale (SFLS 2010).” The notice stated that SFLS 2010 was a sale of unsubsidized mortgage loans assigned to HUD under section 204(a)(1)(A) of the National Housing Act and that the sale was under section 204(g) of the Act. The notice further provided that it applied only to SFLS 2010 and did not establish a policy for the sale of other mortgage loans. HUD later published similar notices for most SFLS note sales in 2010-2016. All of the notices cited the same statutory authority and provided that they did not establish a policy. For the note sales from 2010, there had been eight different sets of requirements for investors to follow when purchasing pooled mortgage loans. Also, since its inception, HUD had issued 31 enhancements, or changes, to its single-family note sales program. HUD did not have a handbook or guidebook that established its formal requirements or policies for the administration of the program.

#### **HUD Officials Did Not Have a Plan To Transition Its Single-Family Note Sales From Demonstration to Official**

HUD officials did not have a plan to transition its single-family note sales from a demonstration program to an official HUD program. In 2002, HUD issued a public notice announcing the ACD demonstration program. In that notice, HUD stated, “The demonstration will have a limited initial duration and will initially include mortgage loans secured by properties located within the jurisdiction of HUD's Philadelphia, Pennsylvania and Atlanta, Georgia Homeownership Centers. At the conclusion of the demonstration, HUD will assess its success and determine whether to implement the demonstration process, on a permanent basis, throughout the country.” HUD did not have a formalized plan in place to assess its success and transition the demonstration program to an official HUD program to implement nationwide. Such a plan might contain goals, outcomes, benchmarks, or other indicators that would identify when HUD intended to move from a demonstration program to an official HUD program.

#### **Conclusion**

As a result of HUD’s not conducting rulemaking, public officials, citizens, and industry participants were not given the opportunity to provide comments for a more than \$18 billion program. Additionally, with no formal procedures or guidebooks, HUD lacked a consistent standard for administering its program. When HUD expanded its notes sales to a nationwide level, it did so without a formal plan to transition from a demonstration to an official program. Because HUD already operates its note sales nationwide, it should complete the rulemaking process and develop formal guidance for administering the program.

## **Recommendations**

We recommend that the Acting Deputy Assistant Secretary of Finance and Budget

- 1A. Complete the rulemaking process for HUD's single-family note sales program.
- 1B. Develop and implement formal procedures and guidance for the note sales program.

# Scope and Methodology

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Our audit work covered the note sales program records from 2010 to 2016. We performed our work from October to December 2016 at HUD headquarters located in Washington, DC.

To accomplish our objective, we

- reviewed HUD's background information on the development and management of the note sales program,
- reviewed the Administration Procedures Act and HUD Handbook 00.2 to determine the requirements for conducting rulemaking,
- reviewed HUD housing notices relating to the note sales that advertised pooled sales and program enhancements,
- reviewed Section 204 of the National Housing Act to determine the agencies' authority to sell FHA mortgage loans through a note sales program,
- interviewed HUD personnel from the Office of Housing and Office of Asset Sales,
- reviewed Office of Asset Sales interoffice communications related to the note sales to determine whether the agency discussed the possibility of conducting rulemaking, and
- reviewed FHA note sales data from 2010 to 2016.

Our review of the single-family note sales data was only to determine the total number of loans sold and the total amount of the unpaid principal balance. We did not select any samples or conduct any further testing on the loan data.

We did not rely on computer-generated data as audit evidence or to support our audit conclusions. We used source documentation obtained from HUD and the auditee for background information purposes. We based our conclusions on source documentation reviewed during the audit.

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

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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:

- Controls to ensure that HUD conducts rulemaking or formalizes procedures for substantive programs.

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 a plan to transition its note sales demonstration program to an official program.

# Appendixes

## Appendix A

### Ref to OIG Evaluation

### Auditee Comments and OIG's Evaluation

#### Auditee Comments

#### Comment 1

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

Office of Housing

JUN 05 2017

MEMORANDUM FOR: Ronald J. Hosking, Regional Inspector General for Audit, TAGA

FROM:   
Susan A. Bell, Acting Deputy Assistant Secretary for Finance and Budget,  
HW

SUBJECT: Response to Discussion Draft Report- HUD Did Not Conduct  
Rulemaking or Develop Formal Procedures for Its Single-Family Note  
Sales Program

Thank you for giving us the opportunity to respond to the Discussion Draft Report- HUD Did Not Conduct Rulemaking or Develop Formal Procedures for Its Single-Family Note Sales Program. The Office of Housing has reviewed the subject draft report. While we agree that our procedures and guidance were never formalized in one single centralized document, the operations of the note sales was and remains guided by a series of well documented procedures used both internally by staff and externally by stakeholders.

For each sale completed to date, the following procedures were developed and utilized:

- **Standardized Bidder Qualifications**
  - Document outlining the qualifications such as such net worth necessary to participate in the sale
- **Bidder Information Package** – Provided to all Qualified Bidders, at a minimum this package contains the materials listed below:
  - Summary Timetables for completing bid application
  - Bid Instructions and Conditions
  - Due Diligence Information on assets
  - Closing Instructions
  - Post Sale Servicing Requirements
  - Loan Eligibility Guidelines
  - Mortgage Loan Pool Stratifications
  - Aggregate Loan Data
  - Bidder's Checklists
  - Bid Terms Acknowledgement Forms
- **Standardized Bid Day Procedures** – Used to manage all aspects necessary to conduct each Single Family Loan Sale auction. At a minimum these procedures contain the materials listed below:
  - Trial Run and Pre-Bid Day System Testing, Readiness and Approval
  - Bidder Documentation Validation Procedures
  - Non-Conforming Document/Bid Procedures
  - Bidding Procedures
  - Bid Model Concurrence

- Participating Servicer Desk Guide – Provided to all Single Family Loan Sale Participating Servicers - at a minimum this Guide contains instructions and materials listed below
  - Defaulted Loan Eligibility Criteria
  - SFLS Claim Identification
  - Post Claim Servicing
  - Document Transfer
  - Communications Protocol
  - SFLS Claim Submission Report and Self Certification Form
  - SFLS Claim Identification Report
  - Broker Price Opinion (BPO) Requirements
  - Preparation of Assignments and Lost Note Affidavits
  - Mortgagee Curtailment Date Instructions for Item 31
  - Required Servicing Transfer Data

We concur with the recommendations; and are currently working on incorporating these procedures and desk guides into one Asset Sales Handbook.

We look forward to working with you and your staff to resolve the issues identified and develop implementable corrective actions. Should you have any questions or need additional information, please contact me at (202) 402-2785.

## **OIG Evaluation of Auditee Comments**

Comment 1 We acknowledge that HUD has informal procedures on the operation and sales of the note sales, however it has not formalized those procedures to allow for public comment on the program. The Office of Housing agrees with the recommendations and the will work with the OIG to close out the recommendations during the audit resolution process.

## **Appendix B – Program Criteria**

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### The National Housing Act

The Housing Act of 1964 authorized HUD to accept assignment of defaulted FHA mortgages, and regulations at 24 CFR Part 291, Subpart D, outlined how HUD can sell pooled mortgage loans. In 1998, Congress amended Section 204 of the National Housing Act (12 U.S.C. (United States Code) 1710) to address various methods by which an FHA lender can make a claim for FHA insurance benefits on defaulted single-family mortgages. Regulations at section 204(a)(1)(A) of the Act provide HUD with the authority to pay claims on assignment of a defaulted FHA-insured mortgage by the FHA lenders. The statute provides that the HUD Secretary must publish guidelines for determining which processes for claiming insurance benefits under section 204(a)(1) are available. HUD regulations at 24 CFR 203.355-.370 previously provided for claims under some of the options in section 204(a)(1), but those regulations have not been amended to provide for claims upon assignment of the defaulted mortgage.

### Administrative Procedure Act

Whether an agency must issue regulations or other notices when implementing a statutory requirement is governed generally by the Administrative Procedure Act. The Act defines a “rule” as “the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services or allowances therefor or of valuations, costs, or accounting, or practices bearing on any of the foregoing.” The Act requires that substantive rules be published in accordance with 5 U.S.C. 552 but provides exemption from this process for interpretive rules, for statements of policy, for good cause published by the agency, or for other exemptions. The Act further provides that rulemaking requirements do not apply to a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts. It is HUD’s policy, however, to provide notice and comment rulemaking even in these areas. Notice and comment requirements may be omitted by the HUD Secretary when the Department determines that the process is impracticable, unnecessary, or contrary to the public interest. The determination must be a part of the rulemaking document.

### HUD Handbook 00.2

HUD Handbook 00.2, Directives Systems documents requirements and procedures for the development, issuance, and maintenance of handbooks. The Handbook implements statutory requirements for record keeping and mandates clearance of directives through the Department. The Handbook compares publication requirements under the Administrative Procedure Act versus the Handbook, stating that directives are intended to supplement statutory or regulatory requirements with practical guidance on implementation. The Handbook further provides that communications that are for the first time relaying guidance

to program participants or related parties – beyond those in existing statutes and regulations – constitute directives.