



Issue Date	August 6, 2010
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Audit Report Number	2010-KC-0002
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TO: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, HU

//signed//

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

SUBJECT: FHA Delayed Sending Violation Notices to Lenders That Did Not Meet
Recertification Requirements

HIGHLIGHTS

What We Audited and Why

In response to a congressional request, we audited the Federal Housing Administration (FHA) Title II single-family lender renewal process. The objective of the audit was to determine whether FHA ensured that lenders submitted recertification forms, annual fees, and audited financial statements in a timely manner.

What We Found

FHA did not ensure that lenders submitted recertification forms, annual fees, and/or audited financial statements in a timely manner. The Lender Approval and Recertification Division (Division) did not promptly issue notices of violation to lenders that did not submit required annual recertification documentation and/or fees when due.

What We Recommend

We recommend that the Office of Lender Activities and Program Compliance require the Division to revise the recertification process to discontinue issuing notices of deficiency and issue notices of violation promptly for all lenders that do not submit or attempt to submit one or more of the required items by the due date. For each recommendation without a management decision, please respond and provide status reports in accordance with U.S. Department of Housing and Urban Development (HUD) Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the discussion draft to HUD on June 15, 2010, and requested a response by July 15, 2010. HUD provided a response on July 21, 2010. HUD formally disagreed with our finding. The complete text of the response, along with our evaluation of that response, can be found in appendix A of this report.

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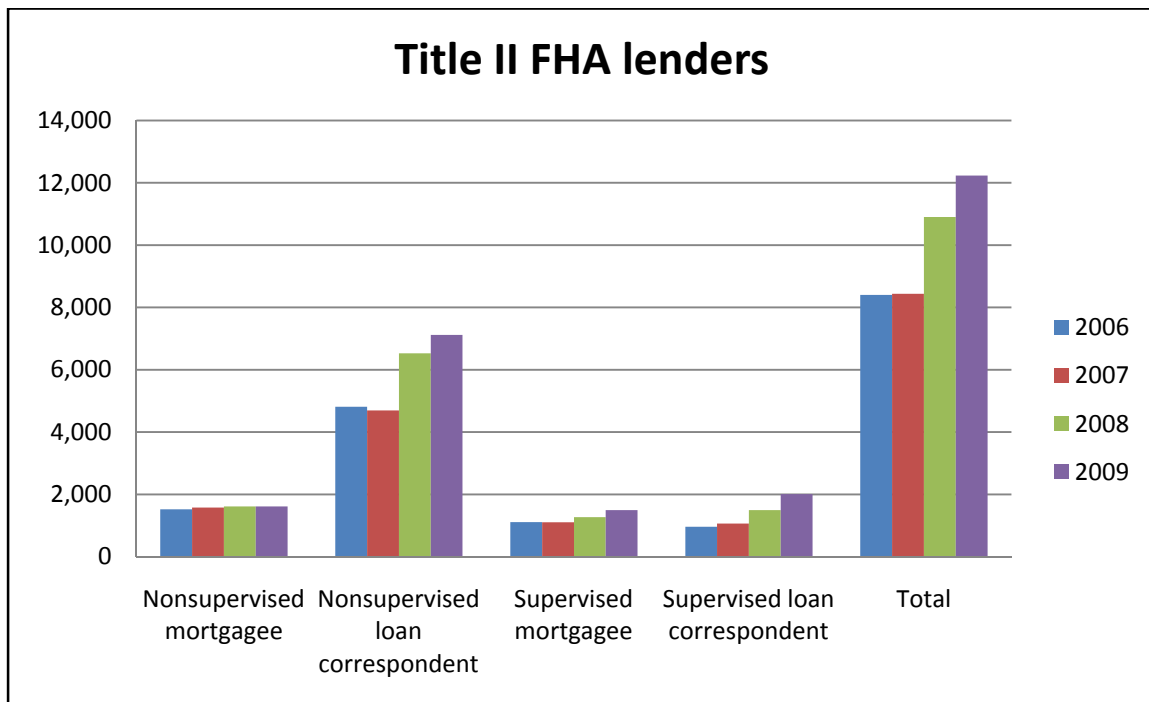
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BACKGROUND AND OBJECTIVE

The Federal Housing Administration's (FHA) mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance encourages lenders to make loans to otherwise creditworthy borrowers who might not be able to meet conventional underwriting requirements by protecting the lender against default.

Title II of the National Housing Act, Section 203(b) is FHA's One- to Four-Family Mortgage Insurance Program. It expands homeownership opportunities for first-time home buyers and other borrowers who would not otherwise qualify for conventional mortgages on affordable terms, as well as for those who live in underserved areas where mortgages may be harder to get. These obligations are protected by FHA's Mutual Mortgage Insurance Fund, which is sustained entirely by borrower insurance premiums.

The number of lenders participating in the FHA program has recently increased. This increase can be attributed to the turmoil in the financial industry and reduced availability of conventional credit. The following chart shows the changes in the number of lenders participating in the FHA program from 8,401 in 2006 to 12,232 in 2009. During 2009, these lenders originated more than two million in loans worth more than \$376 billion.



To maintain status as an FHA-approved lender, lenders must electronically submit a yearly verification report and pay an annual fee for their main and registered branch offices. This action must be completed within 30 days of the lender's fiscal yearend date. Further, lenders are required to electronically submit annual audited financial statements that meet the requirements of the Secretary of Housing and Urban Development within 90 days of the lender's fiscal yearend date. The lender's auditor must verify that the information submitted accurately reflects the paper copy of the statements.

The Office of Lender Activities and Program Compliance oversees the Lender Approval and Recertification Division (Division). The Division is responsible for reviewing recertification items and referring noncompliant lenders to the Mortgagee Review Board (MRB) for possible sanctions. The Division begins this legal process by preparing notices of violation on behalf of the MRB. The HUD Reform Act of 1989 (12 USC § 1708) established the MRB, and the Code of Federal Regulations (24 CFR Part 25) outlines its duties and procedures. FHA-approved lenders who knowingly and materially violate FHA program statutes, regulations, and handbook requirements are subject to administrative sanctions by the MRB.

Before 2008, the Division had authority to withdraw lenders for failure to comply with FHA's annual recertification requirements. The Division lost this authority due to a 2007 administrative hearing ruling. The hearing involved a lender that was withdrawn from the FHA program by the Division for not submitting its audited financial statements on time, although there were extenuating circumstances. The U.S. Department of Housing and Urban Development (HUD) lost this hearing because the lender was not given due process.

In fiscal year 2009, the Federal Housing Commissioner issued mortgagee letters that changed the annual lender recertification process:

- Mortgagee Letter 2009-01 informed lenders that if they failed to complete the recertification requirements in an acceptable, timely manner, they would be brought before the MRB.
- Mortgagee Letter 2009-25 became effective September 1, 2009, and required FHA-approved lenders seeking renewal to complete the electronic annual certification in FHA Connection.
- Mortgagee Letter 2009-31 implemented the Helping Families Save Their Homes Act of 2009, enacted on May 20, 2009. The letter included additional standards that an FHA program participant must meet and required notification of these standards after approval. It also expanded FHA's ability to seek civil money penalties against any owners, officers, or directors of an FHA-approved lender for violations of program requirements. It further required that all supervised lenders submit an annual audited financial statement within 90 days of their fiscal yearend.

On April 20, 2010, HUD published the final rule change for the lender approval and recertification process. As of May 20, 2010, only mortgagees will be required to obtain FHA approval and recertification. Loan correspondents will continue to be authorized to participate in the origination of loans through association with an approved mortgagee, but these entities no longer will be subject to the FHA lender approval process.

Because of the rule change, FHA added 30 days to the fiscal yearend December 31, 2009, loan correspondents' audited financial statement due date. These loan correspondents must continue to comply with existing requirements for the submission of their annual certifications and renewal fees.

Our audit objective was to determine whether FHA ensured that lenders submitted recertification forms, annual fees, and audited financial statements in a timely manner.

RESULTS OF AUDIT

Finding: The Division Delayed Sending Violation Notices to Lenders That Did Not Meet Recertification Requirements

The Division did not promptly issue notices of violation to lenders that did not submit required annual recertification documentation and/or fees when due. This condition occurred because the Division's process for handling noncompliant lenders was not adequate. As a result, FHA insured loans made by noncompliant lenders, putting the insurance fund at risk.

The Division Delayed Sending Violation Notices to Lenders

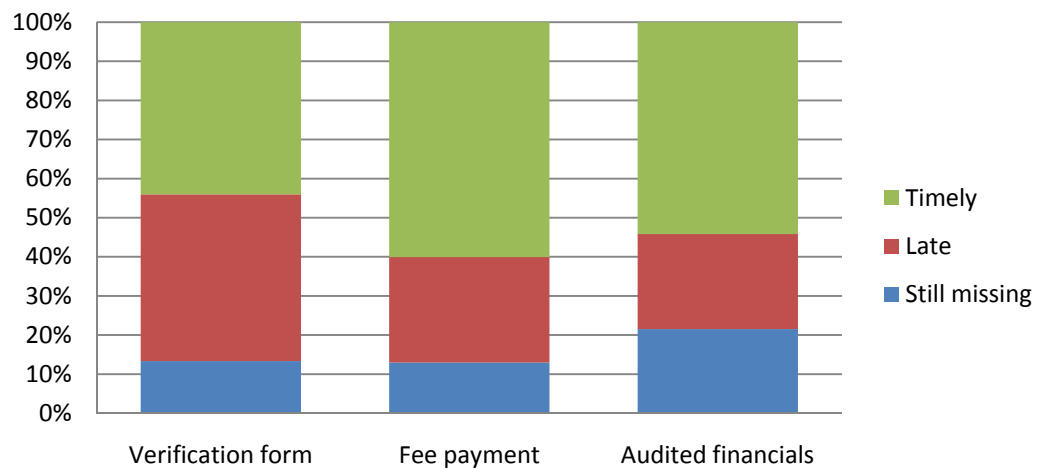
The Division delayed issuing notices of violation to lenders that did not submit required annual recertification documentation and/or fees when due. These notices inform lenders that the MRB is considering administrative sanctions for noncompliance with FHA's annual recertification requirements. Instead of issuing the notices of violation as soon as the recertification submissions were overdue, the Division issued them 7 months after the recertification due date.

The regulations at 24 CFR (Code of Federal Regulations) 202.3(b) state, "Recertification. On each anniversary of the approval of a lender or mortgagee, the Secretary [of HUD] will determine whether recertification, i.e., continued approval, is appropriate. The Secretary will review the yearly verification report required by §202.5(n)(2) and other pertinent documents, ascertain that all application and annual fees have been paid, and request any further information needed to decide upon recertification."

The regulations at 24 CFR 25.6 provide the MRB regulations for lender renewal compliance. The regulations state the failure of a mortgagee to submit its required annual audit report of its financial condition within 90 days of the close of its fiscal year, unless an extension is granted, creates grounds for administrative action. In addition, a failure to comply with any certification or condition of approval also creates grounds for administrative action. This includes the annual submission of the certification form and annual fees within 30 days of the end of the lender's fiscal year. The late submission of the recertification, fee payments and/or annual audit report constitutes a false certification and is therefore subject to administrative action.

Lenders with fiscal years ending on December 31, 2008, were required to submit annual recertification forms and fees by January 31, 2009. Additionally, nonsupervised lenders were required to submit annual financial statements by March 31, 2009. However, more than 5,000 of the 8,000 lenders with a December 31, 2008, fiscal yearend date submitted one or more of the annual recertification documents and/or fees late or not at all. The following chart shows the percentage of recertification items that were on time, late, or not submitted.

Annual submission of recertification items for lenders with a December 2008 yearend

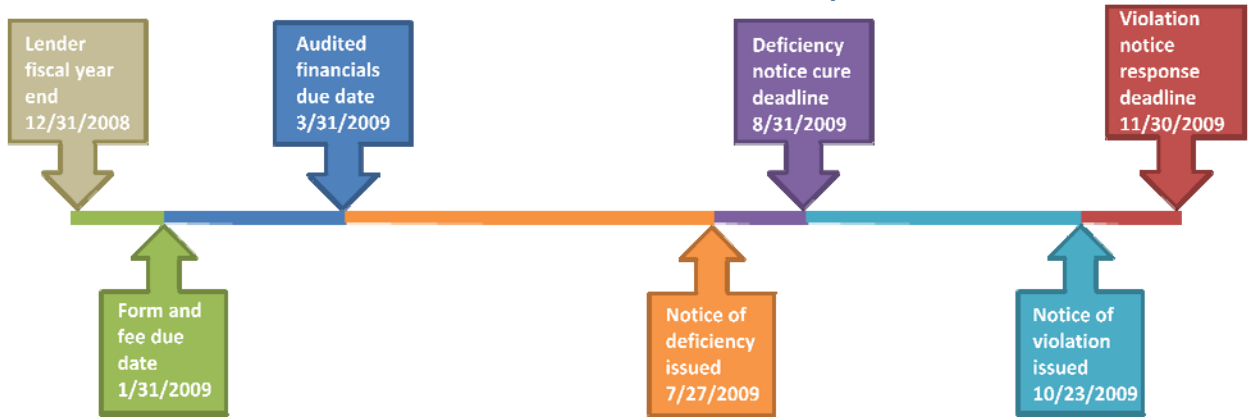


The Division's Process Was Not Adequate

The Division's process for managing lenders with overdue recertification submissions was not adequate to ensure compliance with the recertification requirements. In an attempt to reduce the number of lenders with late submissions, the Division sent a notice of deficiency to the 2,394 lenders that did not submit the required documents and/or fees 4 months after the recertification submission due date. The notice of deficiency informed lenders that they had 30 days to cure the deficiency or they would be referred to the MRB for sanctions. The Division was not required to send the notices of deficiency and only 469 of the 2,394 lenders cured within 30 days of the notice.

Three months after the notifications of deficiency were sent, the Division sent notices of violation to the remaining 1,102 lenders that failed to cure the deficiency. The notice of violation gives the lender 30 days to provide a response. Thirty nine of those lenders completed the submission requirements within 30 days of receiving the notice, thereby curing the deficiency. The Division did not have any policies or procedures addressing when the notices should be issued. The process used by the Division is depicted in the chart below.

Issuance of notices of violation to December 2008 yearend lenders

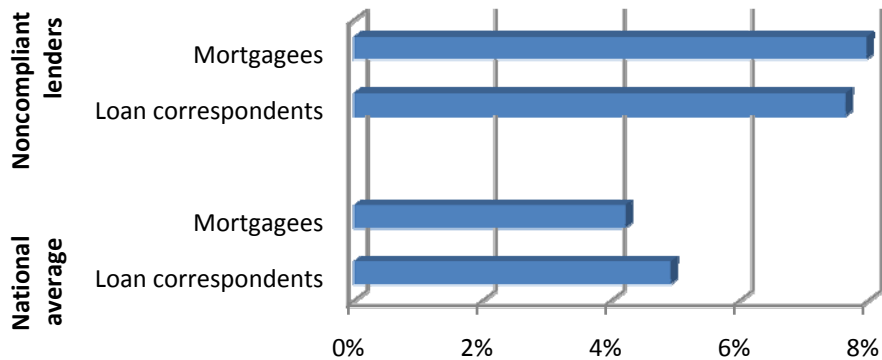


Insured Loans Made by Noncompliant Lenders Put the Insurance Fund at Risk

The Division's delay in issuing notices of violation on behalf of the MRB allowed the noncompliant lenders to originate FHA loans for an additional 7 months. During this period, these noncompliant lenders originated 7,107 FHA-insured loans worth almost \$1.4 billion.

The noncompliant lenders had higher default and claim rates than the national average. We analyzed the default and claim rates for lenders that received a notice of violation for failure to submit one or more of the required items. As shown below, the noncompliant mortgagees had an average default rate that was almost twice as high as the national rate.

Average default and claim percentage



If the Division had issued the notices of violation in a timely manner, the noncompliant lenders would have been sanctioned sooner, limiting the exposure of the FHA fund to loans from these risky lenders.

Recommendation

We recommend that the Office of Lender Activities and Program Compliance require the Division to

- 1A. Revise the recertification process to discontinue issuing notices of deficiency and issue notices of violation promptly for all lenders that do not submit or attempt to submit one or more of the required items by the due date.

SCOPE AND METHODOLOGY

We performed an audit of the FHA single-family annual lender approval process in response to a congressional request. Among other items, the request wanted to know what challenges FHA was facing in enforcing its own rules. On September 30, 2009, we issued Audit Report Number 2009-SE-0004, Controls over FHA's Single-Family Lender Approval Process Need Improvement. Based on the report findings, we decided to audit the lender annual recertification process. Our audit covered 8,080 Title II lenders with December 2008 fiscal yearends that were required to submit annual recertification items. We conducted our fieldwork from October 2009 through April 2010 at the Division in Washington, DC, and in our office.

To accomplish our objective, we

- Reviewed applicable laws and regulations,
- Interviewed appropriate Division and Office of General Council staff,
- Examined MRB meeting documents, and
- Analyzed lender data contained in Single Family Housing Enterprise Data Warehouse (SFHEDW), Neighborhood Watch, Institutional Master File (IMF), and Lender Assessment SubSystem (LASS).

We gained an understanding of the lender recertification process and procedures by interviewing HUD staff and reviewing the laws and regulations affecting FHA lenders' annual recertification. We were informed of an administrative law judge ruling, HUDALJ 07-052-MR, that resulted in the Division's losing its authority to sanction FHA lenders, requiring all noncompliant lenders to go before the MRB. We reviewed this case law, notices sent to lenders not complying with annual renewal requirements, and MRB actions taken against these lenders.

We determined the December 2008 fiscal yearend lenders that did not submit the required items timely by using data provided by the Division from LASS and IMF. The LASS data contained lenders' audited financial statement data including submission dates. The IMF data contained verification form submission dates as well as fee payment dates and amounts. The lender fee payment and financial statement submission dates were system generated, while the verification form submission dates were entered by Division staff. We combined these data files using a database application. We examined the data to determine whether FHA lenders submitted the required annual recertification form, fee, and audited financial statements in a timely manner. We prepared a graph using the combined data that showed the percentage of lenders that were late for each of the three recertification items.

We assessed the reliability of the LASS and IMF data by performing electronic testing for errors in accuracy and completeness. We removed discrepancies, such as inaccurate submission dates and lenders not required to recertify, from the data before our analysis. We considered the submission dates sufficiently reliable in determining the timeliness of lender submissions.

We determined the amount of risk associated with December 2008 fiscal yearend lenders that received a notice of violation. We obtained data from SFHEDW and Neighborhood Watch to establish the activity level and performance of FHA lenders that did not meet deadlines. We used 7 months of SFHEDW data to determine the total number and value of loans originated by noncompliant lenders between March 31 and October 23, 2009. We used the 2 year default and claim rate Neighborhood Watch data as of March 31, 2009, to determine default and claim rates for noncompliant lenders. We created a graph to show noncompliant lenders and total lenders default and claim rates in the report. We did not assess the reliability of the data as the data were only used to demonstrate the potential impact of the finding.

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. 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 an integral component of an organization's management that provides reasonable assurance that the following controls are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 control was relevant to our audit objective:

- Policies and procedures to prevent ineligible lenders from continuing to participate in the FHA program.

We assessed the relevant control identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

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

- HUD allowed lenders to continue conducting FHA business while in noncompliance with recertification requirements.


APPENDIXES

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

	<p>U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT WASHINGTON, DC 20410-8000</p> <p>JUL 21 2010</p> <p>OFFICE OF HOUSING</p>
MEMORANDUM FOR:	Ronald J. Hosking, Regional Inspector General for Audit, 7AGA
FROM:	Vicki B. Bott, Deputy Assistant Secretary for Single Family Housing, HU
SUBJECT:	Discussion Draft Audit Report –Single Family Lender Recertification Process
<p>In response to a Congressional request, the Office of Inspector General (OIG) conducted an audit of FHA's Single Family Lender Recertification Process. The stated objective was to determine whether FHA ensured that lenders submitted a Title II Yearly Verification Report, annual renewal fees, and annual audited financial statements in a timely manner.</p>	
<p><u>AUDIT FINDINGS</u></p>	
<p>The draft audit reported the following finding:</p>	
<ul style="list-style-type: none">• “The Division Delayed Sending Violation Notices to Lenders that Did Not Meet Recertification Requirements”	
<p>The audit asserts this occurred because the Office of Lender Activities and Program Compliance's (OLA) Lender Approval and Recertification Division's process for handling noncompliant lenders was not adequate. Finally, the audit contends that because of inadequate procedures, FHA-insured loans made by noncompliant lenders put the insurance fund at risk.</p>	
<p><u>FHA RESPONSE</u></p>	
<p>FHA agrees that too much time elapsed between the initial time of non-compliance and FHA's action. Furthermore, FHA agrees that the process in place at the time was not adequate to handle the large number of noncompliance violations. However, FHA believes that these issues were addressed well before the issuance of this audit and thus the finding listed above is merely historical reference. As stated in the OIG's draft report, shortly before fiscal year end 2008, the OLA lost its authority to immediately withdraw lenders who failed to comply with FHA's annual lender recertification requirements due to a 2007 ruling by an Administrative Law Judge (ALJ). The 2007 ruling stated that FHA's withdrawal of lenders for failure to comply with recertification requirements did not afford sufficient due process to lenders. This ruling was a major impediment to FHA's ability to ensure timely recertification by approved lenders and this fact was clearly communicated to the audit team.</p>	

Comment 1

Ref to OIG Evaluation

Auditee Comments

Comment 2

Unfortunately, the OIG did not take this major ruling into account when selecting the period of time covered in the audit. As was explained to the audit team over the course of the ten month audit period, prior to 2008, FHA had exercised discretionary authority to terminate lenders that were non-compliant with recertification requirements. This process was efficient and provided a mechanism for prompt resolution of non-compliance. Most notably, by using this process, FHA did not need to go through normal administrative proceedings with the Mortgagee Review Board (MRB). As a general rule, proceedings through the MRB are slow moving due to the various stages of review by program staff, the Office of General Counsel, and MRB staff prior to being scheduled for MRB review. The average life cycle for a MRB case is approximately four months. The drastic change to FHA's process for recertification violations resulted in significant resource strains on the Division and the MRB. As a result of the ALJ ruling, the MRB caseload increased **1806%** from 2008 to 2009, the same period covered in the draft audit.

**Comment 3
Comment 1**

FHA recognized in early 2009 that its existing procedures and staffing levels were not sufficient to ensure swift action against lenders in violation of recertification requirements. Accordingly, FHA took several proactive measures to strengthen its procedures. The procedures are highlighted below:

1. FHA eliminated its paper-based annual verification form and replaced it with an electronic renewal form. This resulted in significant processing improvements. Prior to the electronic renewal form, FHA staff had to manually enter lender recertification data into FHA systems.
2. FHA automated data feeds from its systems to generate Notices of Deficiency (NOD) in a more timely fashion. These automations resulted in improving efficiency by several weeks.
3. FHA created system edits which will not permit an FHA-approved lender to submit its annual renewal fee or audited financial statement without completing the online certification. This process reduces inadvertent omissions of required data.
4. Lender Approval and Recertification staff, in conjunction with staff from the MRB and the Office of General Counsel, developed procedures to handle more routine recertification violations separately from fact-based cases. This has resulted in a drastic reduction in the time necessary to prepare a recertification violation case.
5. FHA increased staffing levels in both the MRB and Lender Approval and Recertification Divisions to better handle recertification and enforcement workload.
6. FHA eliminated the approval of loan correspondents effective May 20, 2010. Effective January 1, 2011, FHA will no longer have any approved loan correspondents. This rule will reduce FHA's approved lender roll by close to 65% which will reduce strain on resources and allow for more timely action by FHA. It is important to note that an estimated one-third of the NOV recipients discussed in the audit are loan correspondents.

Ref to OIG Evaluation

Auditee Comments

These process improvements were all undertaken and completed prior to the issuance of this draft audit. FHA is confident that these measures will improve its ability to ensure timely lender compliance with recertification requirements and take prompt action against those non-compliant lenders.

AUDIT RECOMMENDATIONS

Comment 4

The draft audit recommends that OLA revise its recertification process to discontinue issuing Notices of Deficiency (NOD) and issue Notices of Violation (NOV) promptly to non-compliant lenders. FHA disagrees with this recommendation. FHA strives to provide superior customer service to both lenders and borrowers to ensure that FHA mortgage programs continue to be widely available and accessible. In an effort to strike a reasonable balance between ensuring that the FHA's Mortgage Insurance Funds are protected and ensuring that FHA-approved lenders have an opportunity to address their non-compliance with FHA's annual recertification process, NODs are sent to non-compliant lenders first. The NODs are warning notices which provide lenders and FHA 30 days to rectify any outstanding issues. Lenders failing to come into compliance after receiving the NOD receive a NOV from the MRB.

Comment 5

Caution and time are taken to ensure that the right cases are being sent to the MRB given the lengthy administrative process and limited staffing resources. For these reasons, FHA disagrees with the OIG's recommendation to discontinue the issuance of the NOD and only issue a NOV to any lender missing one or more of the three requisite items needed to complete the annual lender recertification process. Due to the resources used to effectuate the administrative process and the time associated with completing it, the process is better suited for the most egregious instances of lenders' noncompliance (i.e., willful noncompliance) with FHA's annual recertification requirements.

SUMMARY

Comment 6

As stated above, FHA is confident that its policy and procedural changes illustrated above will ensure that timely action is taken against noncompliant lenders without eliminating adequate due process, particularly since this was the reason that HUD had its discretionary authority removed by the Administrative Law Judge ruling in 2007. FHA remains committed to refining its processes and procedures to mitigate risk to its mortgage programs and the insurance fund. To this end, FHA enjoys a strong working relationship with the Office of Inspector General. While FHA agrees that it took too much time to adequately ensure compliance with recertification requirements for December 2008 fiscal year-end lenders, these weaknesses were proactively addressed by FHA well in advance of this audit. Accordingly, FHA must formally disagree with the finding and recommendation contained in the subject audit.

- Comment 1:** FHA is still delaying sending out violation notices to lenders that do not meet recertification requirements. The Division has not sent out notices of violation for December 2009 lenders that did not submit timely recertification items as of the date of this report. The Division sent out notices of deficiency for these lenders in June of 2010 even though these notices are not legally required for due process.
- Comment 2:** The regulations at 24 CFR § 25.2(b)(1) state the MRB can authorize the Division to take nondiscretionary action against lenders.
- Comment 3:** We agree that FHA has taken proactive measures to streamline the process. However it has not significantly affected the time to issue the notices of violation.
- Comment 4:** The Division already provides lenders with reminders 60, 30, and 15 days prior to the recertification due date. Thus lenders that do not submit the recertification items timely are clearly noncompliant with FHA annual recertification requirements, including the requirements in the lenders' annual on-line certification.
- Comment 5:** Lenders are given 3 reminders prior to the recertification date deadlines. Lenders ignoring these reminders are already demonstrating an unwillingness to conform to the recertification requirements. Noncompliant lenders are subject to administrative action by the MRB in accordance with 24 CFR 25.6. Sending NODs to the noncompliant lenders is unnecessary, does not serve as an effective deterrent, and delays referral to the MRB.
- Comment 6:** FHA did not disagree with any factual data included in our report.