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Audit Report Number 2012-PH-0002
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TO: Deborah C. Holston, Acting Deputy Assistant Secretary for Single Family Housing, HU  
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FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: HUD's Philadelphia, PA, Homeownership Center Generally Monitored Loan Originations in Compliance With Requirements

## **HIGHLIGHTS**

### **What We Audited and Why**

In accordance with our audit plan, we audited the U.S. Department of Housing and Urban Development's (HUD) Philadelphia, PA, Homeownership Center's quality assurance procedures for monitoring originations of Federal Housing Administration (FHA) single-family mortgage loans. Our audit objective was to determine whether the Homeownership Center properly monitored single-family loan originations in its jurisdiction by implementing quality assurance procedures for single-family mortgage loan originations in compliance with HUD requirements.

### **What We Found**

The Homeownership Center generally monitored loan originations in its jurisdiction in compliance with HUD requirements. It met or exceeded its lender review target goals for each performance period within the audit period. It also properly reviewed loan originations for compliance with HUD requirements regarding borrowers' cash assets used to meet the minimum required investment, employment and income records, liabilities, and credit characteristics.

## **What We Recommend**

This report contains no recommendations.

## **Auditee's Response**

We discussed the draft report with HUD during the audit and at an exit conference on December 6, 2011. HUD did not provide written comments to the report because there were no recommendations

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## BACKGROUND AND OBJECTIVE

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The Federal Housing Administration (FHA) is an organizational unit within the U.S. Department of Housing and Urban Development (HUD) that 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, and currently has 4.8 million insured single-family mortgages. FHA mortgage insurance provides lenders with protection against losses as the result of homeowners defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default. Loans must meet certain requirements established by FHA to qualify for insurance.

HUD's Office of Housing is responsible for the overall management, policy development, and administration of FHA mortgage insurance programs. Under the Office of Housing, the Office of Lender Activities and Program Compliance oversees FHA lenders. Within that office, the Quality Assurance Division performs lender oversight functions. The purpose of the Quality Assurance Division is to protect HUD from unacceptable risk by assessing lender performance, internal controls, and compliance with HUD origination and servicing requirements, as well as requiring corrective measures or initiating enforcement actions as appropriate. The Quality Assurance Division performs its oversight functions at HUD's headquarters in Washington, DC, and at HUD's four Homeownership Centers located in Atlanta, GA, Denver, CO, Philadelphia, PA, and Santa Ana, CA. The Homeownership Centers assess or review lenders' performance, internal controls, and compliance with HUD loan origination requirements through onsite and offsite reviews, evaluations, and analyses. The lender reviews are completed by local Quality Assurance Divisions within the Homeownership Centers and are generally based on an annual lender targeting plan developed by the headquarters Quality Assurance Division. The target plan is based on various factors, including but not limited to loans underwritten, previous monitoring reviews, volume, and product-related risk. The headquarters Quality Assurance Division also incorporates input from the Homeownership Centers into its targeting methodology. The plan is revised quarterly to reflect changes that occur during the fiscal year as appropriate.

The Philadelphia, PA, Homeownership Center's jurisdiction covers Connecticut, Delaware, the District of Columbia, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, and West Virginia. Therefore, its Quality Assurance Division reviewed lenders in those areas as assigned by the headquarters Quality Assurance Division and as dictated by its local lender monitoring needs.

Our objective was to determine whether the Homeownership Center properly monitored single-family loan originations in its jurisdiction by implementing quality assurance procedures for single-family mortgage loan originations in compliance with HUD requirements.

## RESULTS OF AUDIT

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### Finding: The Homeownership Center Generally Monitored Loan Originations in Compliance With Requirements

The Homeownership Center generally monitored loan originations in its jurisdiction in accordance with HUD requirements. It met or exceeded its lender review target goals for each performance period within the audit period. It also appropriately monitored FHA lenders' underwriting practices by properly reviewing their loan originations for compliance with applicable HUD requirements. By monitoring loan originations in accordance with requirements, the Homeownership Center contributed to the Quality Assurance Division's goal to protect HUD from unacceptable risk.

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#### **The Homeownership Center Met or Exceeded Its Lender Review Target Goals**

The Homeownership Center met or exceeded its assigned lender review target goals during the audit review period. The goals were assigned via lender targeting plans developed by the headquarters Quality Assurance Division and disseminated to HUD's four Homeownership Centers. Based on a review of targeting plans and other data obtained from the headquarters Quality Assurance Division, we determined that the Homeownership Center met or exceeded its annual lender review target goals between fiscal years 2009 and 2011 as shown in the table below.<sup>1</sup>

<b>Fiscal year</b>	<b>Goals</b>	<b>Accomplishments</b>
2009	85	89
2010	86	86
2011	73	75

Based on the data above, the Homeownership Center met its goal for fiscal year 2010 and exceeded its goals in fiscal years 2009 and 2011.

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<sup>1</sup> The Homeownership Center's goals and related accomplishments reflect origination and servicing reviews; however, origination reviews made up more than 50 percent of the goals and accomplishments for each fiscal year.

## **The Homeownership Center Generally Reviewed Loan Originations as Required**

The Homeownership Center generally performed loan origination reviews in accordance with internal policies and program requirements. It targeted high-risk lenders for review as assigned by the headquarters Quality Assurance Division and properly assessed their loan originations for compliance with HUD's underwriting requirements. We evaluated the Homeownership Center's review of originations by reexamining 12 of a random audit sample of 14 cases it reviewed during the audit period. For the 12 cases, we reexamined applicable loan documents to determine whether the loans were originated in compliance with HUD requirements. We reviewed the borrowers' cash assets used to meet the minimum required investment, employment and income records, liabilities, and credit characteristics and did not identify any significant discrepancies or deviations from HUD requirements. We also found that the Homeownership Center documented its reviews in accordance with requirements outlined in the quality assurance desk guide developed by the headquarters Quality Assurance Division.

For the remaining 2 of the 14 sample cases, we could not evaluate the Homeownership Center's reviews because the loan files it provided were incomplete. The files were missing key documents required for loan origination including the loan application, sales agreement, mortgage credit analysis worksheet, form HUD-1, Internal Revenue Service forms W-2, and pay stubs. The files were for loans that had been originated under the single-family direct endorsement program.<sup>2</sup> Therefore the Homeownership Center had to request the related files from the lenders. We contacted the lenders directly to attempt to obtain the missing documents; however, we were unsuccessful because one lender had since merged with another lender and the other lender had been taken over by a new lender. According to HUD requirements, originating lenders are required to maintain loan origination case binders (files) for a period of 2 years from the date of endorsement. The two loans in question were both originated or underwritten more than 2 years ago. Therefore, we did not pursue either case.

## **Conclusion**

The Homeownership Center generally monitored loan originations in accordance with applicable requirements. It met or exceeded its lender review target goals for the period reviewed and also properly reviewed loan originations to ensure that FHA lenders underwrote loans in compliance with HUD requirements, thereby

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<sup>2</sup> The direct endorsement program authorizes approved lenders to underwrite loans without HUD's prior review and approval. Participating lenders are not required to submit loan files (case binders) to HUD unless requested to do so.

contributing to the Quality Assurance Division's goal to protect HUD from unacceptable risk.

## SCOPE AND METHODOLOGY

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We performed our audit at HUD's Philadelphia, PA, regional office and our offices in Philadelphia and Pittsburgh, PA, from March through October 2011. The audit covered the period March 2009 through February 2011 but was expanded when necessary to include other periods. We partly relied on computer-processed data for loan origination reviews. Although we did not perform a detailed assessment of the reliability of data, we performed a minimal level of testing and found the data to be adequate for our purposes. The testing entailed matching electronic data on loan origination reviews to hard copy case file documentation for the loans.

To accomplish our objective, we

- Obtained relevant background information.
- Reviewed applicable HUD rules, regulations, and guidance.
- Interviewed various HUD personnel in headquarters and the Homeownership Center to determine the following:
  - The role of the Homeownership Center's Quality Assurance Division and headquarters in the implementation of policies and directives on lender targeting and monitoring.
  - Duties, responsibilities, and functions of the personnel at the Homeownership Center's Quality Assurance Division.
  - The review process for loan originations.
- Reviewed case files for 12 loans including related review finding letters.

We also reviewed the quality assurance desk guide developed by the headquarters Quality Assurance Division. The desk guide describes the Quality Assurance Division's process for targeting high risk lenders, preparing for various reviews and related documentation requirements. The desk guide was last updated in 2008 and is currently undergoing an update. We reviewed the guide to determine the Quality Assurance Division's methodology for lender targeting, loan origination reviews and related documentation requirements.

We identified a universe of 6,738 loans originated by 135 lenders, which were reviewed by the Homeownership Center during the audit period as recorded in HUD's Approval Recertification and Review Tracking System. We then used statistical sampling to generate a random sample of 67 loans. Based on this sample, we randomly selected 14 loans for a preliminary review to determine whether there were any problems with the Homeownership Center's loan origination reviews. We asked the Homeownership Center to provide the loan case files and origination review documentation for the 14 loans. The Homeownership Center provided the files and documentation; however, we could only assess its reviews of 12 loan originations because the



files related to the remaining 2 were incomplete. Our review of the 12 files disclosed that the Homeownership Center generally reviewed originations in accordance with internal policies and program requirements; therefore, we did not review the remaining 53 loans in our sample.

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.

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## Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meet its objectives.
- Validity and reliability of data – 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 laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resources 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.

We evaluated internal controls related to the audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of the Homeownership Center's internal control.