U.S. Department of Housing and Urban Development

Office of Inspector General

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MEMORANDUM FOR: John P. McCarty, Assistant Inspector General for Inspections and Evaluations, Office of Investigation, GI

FROM: Michael K. Groszkiewicz, Special Agent in Charge, Inspections and Evaluations Division, GIH,

SUBJECT: Preforeclosure Sales Program in Region III
File: IED-07-007

Executive Summary

We completed an evaluation of the preforeclosure sales program in Region III. Our objectives were to determine whether mortgagees administered the program in compliance with Federal Housing Administration (FHA) requirements and whether these procedures effectively limited the risk of program fraud and abuse.

We determined that mortgagees technically complied with most FHA requirements in administering the program for the homes tested in our sample. However, we also found that current FHA program guidelines were not adequate to ensure that several homes approved for preforeclosure sale were sold at fair market or optimum value. As a consequence, the U.S. Department of Housing and Urban Development (HUD) may be incurring higher insurance claims than necessary on some properties sold through this loss mitigation program. Although modest in terms of volume and the total dollar amount of FHA insurance claims, preforeclosure sales, therefore, remain inherently vulnerable to investor exploitation as well as fraud schemes.

Background

A preforeclosure or "short" sale is a sale of an FHA-insured property, at fair market value, by a borrower who has been delinquent on his/her mortgage payments for 3 or more months. The mortgagee agrees to accept the net sales proceeds from this transaction as satisfaction of a defaulted mortgage even though it is less than the unpaid mortgage indebtedness. The mortgagee can then submit a claim to HUD for the difference plus certain costs, expenses, and debenture interest. FHA encourages mortgagees to use its preforeclosure sales program to help financially troubled borrowers who want to avoid foreclosure but cannot meet their mortgage obligations. It is one of several loss mitigation options that mortgagees are required to consider when servicing defaulted FHA single-family insured loans.

Preforeclosure sales activity has been modest in recent years. Nationwide, mortgagees submitted approximately 5,000 claims involving preforeclosure sales in 2005 and 4,500 in 2006, or less than 8 percent of FHA conveyance claims in those 2 years. In Region III, mortgagees submitted 100 claims in 2005 and 75 in 2006. Average claims were $17,535 and $18,346 in 2005 and 2006, respectively.

The Office of Inspector General issued an internal audit report (2005-LA-001), dated September 13, 2005, that found preforeclosure sales in Region IX were not closed at the fair market value of the homes. In response, FHA has prepared a draft mortgagee letter to address the program defects identified in that report. Our Region III inspection was conducted to determine whether the same program risks were present in a different geographical area and, therefore, represents a multiregional concern.

Scope and Methodology

We identified 479 Region III claims in FHA's Single Family Data Warehouse, in which borrowers' last payment dates occurred between calendar years 2002 and 2006 and their mortgage loan defaults were settled through preforeclosure sales transactions. Records related to 24 of the highest dollar amount ($29,800 or more) preforeclosure sales claims were requested from mortgagees for examination. These 24 claims represented approximately 5 percent of the claims filed and 12 percent of the total dollar amount of preforeclosure sales claims paid for the period. Mortgagees were not able to locate any records related to three preforeclosure sales.

We tested compliance with HUD parameters for preforeclosure eligibility. These tests included

- Determining whether the borrower was an owner-occupant or an investor,
- Identifying the reason for default,
- Comparing the appraised property value to outstanding mortgage indebtedness to verify that value equaled at least 63 percent of indebtedness,
- Comparing anticipated net sales proceeds to appraised value to ensure that proceeds equaled at least 82 percent of value,
- Reviewing records provided by the servicing lenders to determine whether
    - The borrower had marketed the property to obtain the best possible offer

    - The appraisals had been obtained by lenders as required, and

- Researching available public databases to determine whether the property had been resold at a higher price within a short time after the preforeclosure sale.

Observations

We determined that mortgagees technically complied with most FHA procedures when administering the preforeclosure sales program. Our tests showed that for each preforeclosure sale for which records were available, borrowers approved for participation in the program were eligible based on occupancy of the property as a primary residence, the mortgage default was due to a verifiable decrease in the borrower's income or increase in living expenses, and the ratios of appraised property value to outstanding mortgage indebtedness and of net mortgage proceeds to appraised value met FHA-required thresholds.

However, research of public records showed that, as it is presently designed, the preforeclosure sales program has inherent defects that real estate investors could exploit for their own benefit. Records related to the 21 preforeclosure sales had indicators that borrowers and mortgagees did not obtain the highest possible sales prices when accepting buyers' offers to purchase:

- Four properties were resold or "flipped" at higher prices within 10 days of the preforeclosure short sale. In two of these cases, the properties were resold on the same day.

- Three appraisals were apparently obtained by the property buyers rather than the lenders as required by HUD.

- Four borrowers apparently made no attempt to market their properties by engaging a real estate agent before agreeing to a deal with the buyers. The settlement statements (form HUD-1) indicated that either no real estate commission was paid or it was minimal (1.5 percent).

- In one instance, the borrower executed an exclusive listing agreement with a real estate agent that showed an initial listing price equal to the appraised value. Moreover, there appeared to be an identity of interest between the buyer, a limited liability corporation, and the broker because each listed the same Maryland address.

For the these loans, HUD did not have adequate assurance that the properties were sold at fair market value and that resulting claims against the FHA insurance fund were minimized. These observations mirror the 2005 findings reported by the Office of Inspector General on preforeclosure sales in Region IX.

Recommendations

We are providing this report as a management advisory only and not making formal recommendations. HUD is presently addressing the vulnerabilities identified in this report through the audit resolution process related to Audit Report 2005-LA-001.

Acknowledgements

The report was prepared under the direction of Ruth A. Ritzema, Deputy Assistant Inspector General for Inspections and Evaluations, Office of Inspections.

The assignment was supervised by Michael Groszkiewicz, Special Agent in Charge, Inspections and Evaluations Division, Office of Investigation.

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