U. S. Department of Housing and Urban Development

Office of Inspector General for Investigation

Inspections and Evaluations Division

Evaluation of the Effectiveness of HUD's Credit Watch Termination Initiative in Deterring Deficiencies in the Performance of Lenders' Loans

September 29, 2010
IED-10-003

Executive Summary

The Office of Inspector General (OIG), Inspections and Evaluations Division, conducts independent, objective examinations of U.S. Department of Housing and Urban Development (HUD) activities, programs, operations, and organizational issues.

We evaluated HUD's Credit Watch Termination Initiative (Credit Watch) to determine whether it was used effectively to deter deficiencies and substandard performance in Federal Housing Administration (FHA) single-family lending. We also sought to determine whether Credit Watch could be manipulated, allowing lenders to avoid HUD's scrutiny and program sanctions. While we noted a past instance in which a lender manipulated the Credit Watch program to avoid HUD scrutiny (i.e., closing an "at-risk" branch office approaching the 200 percent termination threshold and then opening a new branch office in the same lending area to originate loans), our review did not disclose a systemic problem.

Under Credit Watch, HUD has the authority to address deficiencies in a lender's performance, such as termination of a lender's approval to originate FHA-insured loans in an area where its default and claim rate exceeds the established thresholds. The termination of a lender's approval using the Credit Watch default and claim analyses is separate and apart from any action taken by HUD's Mortgagee Review Board.

Credit Watch is managed by the Quality Assurance Division (QAD) of HUD's Office of Lender Activities and Program Compliance (Lender Activities) within the Office of Single Family Housing in Washington, DC. We met with and interviewed the Director of Lender Activities, senior management and staff of QAD, and staff of HUD's Office of General Counsel. We selected and examined a sample of case files maintained by QAD, supporting its staff analyses and termination decisions involving lenders with high default and claim rates, as identified in the Credit Watch report for the quarter ending March 31, 2009. We also reviewed third-party records to gain insight into the mortgage industry's interactions with the Office of Single Family Housing.

As designed, the Credit Watch statistical reports effectively identified lender branch offices with unacceptably high default and claim rates for loans originated within the preceding 24 months,[1] and QAD staff followed existing policies and procedures in analyzing these reports before forwarding them to management for final termination decisions. However, we observed the following during the course of our evaluation:

- <u>Before January 21, 2010, the Credit Watch analyses and sanctions were narrower in scope than permitted by Federal regulations at 24 CFR (Code of Federal Regulations) 202.3</u>. Analysis did not include review of a lender's direct endorsement underwriting activities. QAD only reviewed the loan default and claim rates for lender branch offices, and termination was limited to FHA loan origination authority at the branch level within specified HUD field office areas.

[1] Ratios in excess of 200 percent of the jurisdictional HUD field office default and claim rate and also above the national default and claim rate.

- Results of the Credit Watch analyses could benefit other departmental oversight efforts. Information such as data on early defaulted loans and problem lender employees identified during the Credit Watch review and appeal process by QAD was not routinely shared or coordinated with other departmental oversight efforts. This information could have been used by the Homeownership Centers to determine whether other actions were warranted, such as a fact based review of lender operations or referral to the HUD OIG.

- Formal policies for proposed termination actions were not available, and records were incomplete. QAD has a formal policy for drawing down Credit Watch reports and for updating HUD's databases with termination actions. However, it does not have written policies for proposed termination actions or for maintaining a complete historical record of the process and results. Documentation supporting management decisions for postponing termination actions was not always evident in QAD case files.

We noted one other matter that requires follow up by the Office of Single Family Housing. For the quarter ending March 31, 2009, approximately 3,000 lender branches were automatically eliminated from further review under Credit Watch, although they had default and claim rates in excess of the 200 percent termination threshold. While most of the eliminated branches had fewer than 10 defaults and claims, the QAD did not have a formal written policy of the procedures to determine the de minimis amount and did not provide support for the basis of the de minimis amount used. To ensure that the Credit Watch process does not lose its deterrent effect, procedures used for determining the de minimis amount should be formally documented.

On January 21, 2010, HUD enhanced the Credit Watch program through issuance of Mortgagee Letter 2010-03, when it fully exercised its regulatory authority by extending its termination procedures to include underwriting as well as loan origination. While this regulatory authority had been in effect for 4 years, it was not implemented until recently due to FHA's very small market share and the desire of HUD to attract and retain lenders to originate and underwrite FHA loans. Per QAD management, the capabilities of Neighborhood Watch also contributed to the delayed implementation, and advised that they implemented the new procedures beginning with the quarter ending December 31, 2010. Accordingly, no recommendation has been made in this report.

Going forward, for Credit Watch to be a more effective tool in HUD's overall risk management efforts, the Office of Single Family Housing should ensure that the recent termination procedures are effectively implemented and a coordinated approach is taken to integrate the Credit Watch results with other departmental oversight activities. Further, standardizing the Credit Watch file documentation and procedures will improve and strengthen the CreditWatch process.

We provided a copy of the formal draft report on September 1, 2010, to the Assistant Secretary for Housing – Federal Housing Commissioner. While HUD's Office of Single Family Housing disagreed with observations 2, 3, and the other matter reported they advised us that QAD is developing standard operating procedures to "better manage the implementation of its Credit Watch activities." Recommendations 1 through 4 remain open pending verification of corrective actions taken. The complete text of the response is included in appendix A.

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Introduction

Legal Authority

In 1987, Congress enacted the Housing and Community Development Act, Public Law No. 100-242, which included specific directives on actions that the U.S. Department of Housing and Urban Development (HUD) should take to reduce losses in the Federal Housing Administration (FHA) single-family mortgage insurance program. One provision of the law, codified at 12 U.S.C. (United States Code) 1735f-11, directed the HUD Secretary to review annually the rates of "early serious defaults and claims" on FHA-insured loans and required approved mortgagees (lenders) experiencing a high rate of early defaults and claims to submit a report that would explain the reasons for the higher than normal rate and if applicable, set forth a plan of corrective action.

Credit Watch Termination Initiative

In September 1998, HUD promulgated regulations at 24 CFR (Code of Federal Regulations) 202.3(c)(2), setting forth the circumstances under which it would propose terminating a lender's FHA origination approval agreement due to high default and claim rates. In May 1999, HUD issued Mortgagee Letter 99-15, advising lenders that every 3 months, HUD would systematically review lenders' default and claim rates covering loans endorsed for insurance (later amended to loans amortized) in the preceding 24 months. The statistical analysis, known as the Credit Watch Termination Initiative (Credit Watch), focuses on the performance of participating lender branches in geographic areas served by a HUD field office and is based on compare ratio thresholds established by HUD (i.e., default and claim rates of a particular lender compared to the default and claim rates of all lenders in the HUD field office area). Credit Watch is a "snapshot" of the performance of a lender's loans at the end of a particular fiscal year quarter, and the default and claim status of loans at the end of each quarter is the driver for Credit Watch purposes.

Initially, HUD placed lenders on Credit Watch status (an early warning notification that their rates were high and should be remedied) when a branch office's default and claim rate exceeded the field office rate by 200 percent. This threshold was later reduced to 150 percent. The early warning notification was no longer deemed necessary by HUD when it provided lenders with access to monitor their performance via the Web using HUD's Neighborhood Watch Early Warning System (Neighborhood Watch).

Under Credit Watch, HUD initially considered terminating a lender's authority to originate loans in a specific geographical area if a lender's branch office default and claim rate exceeded the national average and also exceeded the average local HUD field office default and claim rate by 300 percent. By June 2003, the termination thresholds had been reduced to 200 percent. If a lender had more than one branch office facing a Credit Watch termination action in a particular period, HUD reserved the right to evaluate the overall performance of the lender in that field office jurisdiction and, if unacceptable, terminate a lender's ability to originate loans in the entire jurisdiction. The termination of a lender's loan origination agreement using the Credit Watch default and claim analysis is separate and apart from any action taken by HUD's

Mortgagee Review Board (MRB) due to a lender's violation of HUD requirements and does not affect the lender's authority to purchase, hold, or service FHA-insured loans.

The latest revisions to the Credit Watch regulations at 24 CFR 202.3(c)(2) were published as a final rule on January 30, 2006, and became effective on March 1, 2006. The rule, in part, provided that the default and claim rate thresholds underlying the Credit Watch program applied not only to originating lenders, but also to underwriting lenders (i.e., direct endorsement lenders).

HUD Administration

The Director of the Office of Lender Activities and Program Compliance (Lender Activities) oversees the overall implementation of the Credit Watch program for HUD, and the Quality Assurance Division (QAD) within this office is responsible for the day-to-day management of the program. QAD has a staff of seven analysts who are assigned generally between three and four proposed termination cases to administer each Credit Watch round (a fiscal year quarter) in addition to their other duties. At the time of the Credit Watch quarter ending March 31, 2009, only one analyst had the responsibility to initiate the quarterly Credit Watch reviews by drawing down the Credit Watch report from Neighborhood Watch. More recently, additional analysts have been assigned to assist in these efforts.

We evaluated HUD's Credit Watch program to determine whether it was used effectively to deter deficiencies and substandard performance in FHA single-family lending. We also sought to determine whether Credit Watch could be manipulated, allowing lenders to avoid HUD's scrutiny and program sanctions. While we noted a past instance in which a lender manipulated the Credit Watch program to avoid HUD scrutiny (i.e., closing an "at-risk" branch office approaching the 200 percent termination threshold and then opening a new branch office in the same lending area to originate loans), our review did not disclose other instances in which Credit Watch manipulation and avoidance occurred.

Scope and Methodology

To understand Credit Watch and its implementation by HUD, we reviewed the legislative history, public law and HUD requirements and policies as reflected in 24 CFR 202.3, and various HUD mortgagee letters. We interviewed various employees of Lender Activities and HUD's Office of General Counsel to gain a better understanding of the history of the Credit Watch program and its current operations. To assess HUD's vulnerability to manipulation of Credit Watch by lenders, we also obtained and reviewed documents from third parties.

We examined a sample of 26 lender branches from a universe of 118 lender branches listed on the Credit Watch report provided by QAD for the quarter ending March 31, 2009. We also obtained historical default data from Neighborhood Watch for the 26 lender branches selected for review. The review focused on Credit Watch activity for the 2-year period ending March 31, 2009, and included review of prior or subsequent QAD actions when deemed necessary.

The table below represents QAD's Credit Watch activity for the past eight quarters ending September 30, 2009.

Quarter ending	Branches				
	Exceeded Credit Watch thresholds ♦	Held for next quarter review	Received proposed termination	Terminated	Withdrawal of proposed termination
31-Dec-07	21	5	16	11	5
31-Mar-08	13	2	11	10	1
30-Jun-08	20	8	12	9	3
30-Sep-08	40	7	33	22	11
31-Dec-08	28	9	19	16	3
31-Mar-09	62	31	31	25	6
30-Jun-09	75	42	33	29	4
30-Sep-09	123	75	48	40	8
	382	**179**	**203**	**162**	**41**

♦ These totals exclude branches for which prior Credit Watch actions were taken by QAD (i.e., terminations, proposed terminations, and withdrawals of proposed terminations). For example, as of March 31, 2009, there were 118 branches that exceeded Credit Watch thresholds, and 56 branches were manually removed because prior period actions continued to appear on subsequent Credit Watch reports. A total of 62 branches were analyzed by QAD for that quarter.

We conducted the evaluation in accordance with the *Quality Standards for Inspections*, issued by the President's Council on Integrity and Efficiency.

Observations

As designed, the Credit Watch statistical reports effectively identified lender branch offices with default and claim rates that exceeded HUD established thresholds. Also, QAD staff followed existing policies and procedures in analyzing these reports before forwarding them to management for final termination decisions. However, we observed that the Credit Watch analyses were narrower in scope than permitted, results were not routinely shared or coordinated with other oversight efforts, and procedures and documentation were not standardized. We noted one other matter concerning the de minimis amount established by QAD.

Observation 1: Credit Watch Analyses and Sanctions Were Narrower in Scope Than Permitted

For a period of more than 4 years, Lender Activities did not exercise its regulatory authority under the Credit Watch program to scrutinize the default and claim rates of direct endorsement lenders or terminate a lender's approval to underwrite loans when its default and claim rates exceeded program thresholds. Instead, QAD staff in headquarters focused only on the defaults and claims of loans originated by individual branch offices and terminated only a branch's authority to originate loans in a specific HUD field office jurisdiction. This narrow scope approach limited HUD's oversight of high-risk lenders under the Credit Watch program, allowing direct endorsement lenders to avoid scrutiny under the program.

Revisions to the Credit Watch regulations set forth in 24 CFR 202.3(c) (2) were first published by HUD as an interim rule on December 17, 2004, and became effective January 18, 2005. HUD reviewed public comments on this interim rule and did not make any changes. On January 30, 2006, HUD then published a final rule, which took effect on March 1, 2006. The final rule (FR-4625-F-03) provided that the default and claim thresholds underlying the Credit Watch program applied not only to originating lenders, but also to underwriting lenders. Further, the preamble to the final rule stated that the proposed regulatory changes were "designed to improve the Credit Watch Termination Initiative, thereby strengthening HUD's capacity to safeguard the FHA mortgage insurance fund."

The amended Credit Watch regulations at 24 CFR 202.3(c) (2) stated:

> The Secretary will review, on an ongoing basis, the number of defaults and claims on mortgages originated, **underwritten**, or both, by each mortgagee in the geographic area served by a HUD field office. … The Secretary may also review the insured mortgage performance of a mortgagee's branch offices individually and may terminate the authority of the branch or the authority of the **mortgagee's overall operation**....

These regulations also described the procedures for HUD to follow when terminating a lender's underwriting approval:

> The Secretary may notify a mortgagee that its direct endorsement approval under 24CFR Part 203 will terminate 60 days after notice is given, if the mortgagee had a rate of defaults and claims on insured mortgages underwritten in an area which exceeded 200 percent of the normal rate and exceeded the national default and claim rate for insured mortgages….

Not until January 21, 2010, through the issuance of Mortgagee Letter 2010-03, did HUD establish Credit Watch procedures to address deficiencies in loan performance by direct endorsement lenders. The Director of Lender Activities advised that the delay in implementation of the revised Credit Watch regulations was due to FHA's very small market share and the desire of HUD to attract and retain lenders to originate and underwrite FHA loans. Per QAD management, the capabilities of Neighborhood Watch also contributed to the delayed implementation, and advised that they implemented the new procedures beginning with the quarter ending December 31, 2009. Accordingly, no recommendation has been made in this report.

The recent inclusion of lender underwriting in its Credit Watch program is a positive step taken by the Office of Housing to strengthen HUD's capacity to safeguard the FHA mortgage insurance fund, and moving forward it is necessary to ensure that these procedures are effectively implemented.

Observation 2: Credit Watch Results Could Benefit Other Oversight Efforts

The Credit Watch process is handled separately and apart from other Lender Activities oversight efforts, including the targeted, in-depth FHA underwriting and compliance reviews conducted by its four Homeownership Centers (HOCs). While QAD in HUD headquarters copies the QAD Directors at the HOCs on proposed and final terminations, information obtained during the Credit Watch process is not routinely shared or coordinated with other departmental oversight efforts.

Our review of the sampled case files disclosed that QAD obtained information during the Credit Watch process that would have been helpful to the HOCs had it been shared; for example, data on early defaulted loans and problem lender employees. This information could have been used by the HOCs to determine whether other actions were warranted, such as a fact based review of lender operations or referral to the HUD Office of Inspector General (OIG). The following are examples of information included in the QAD case files:

<u>Example A[2] - Greensboro, NC, Jurisdiction</u>

In a letter dated August 24, 2009, the lender notified Lender Activities that a contributing factor to its high loan default rate was the performance of two underwriters whose employment the lender had terminated. This information could have been referred to the Atlanta HOC to determine whether a fact-based review of other loans underwritten by the two individuals was warranted. An in-depth review by the HOC may have resulted in recommendations leading to improved lender operations, indemnifications of loans, or other administrative sanctions.

<u>Example B -Washington, DC, Jurisdiction</u>

In a letter, dated August 27, 2009, the lender notified Lender Activities that a former licensing manager had permitted branch offices other than its Fairfax, VA, branch office to order FHA case numbers using the Fairfax office's branch identification number. This information could have been shared with the Philadelphia HOC office to determine whether an in-depth review or other actions were warranted.

<u>Example C - Philadelphia, PA, Jurisdiction</u>

In a document received by Lender Activities on August 14, 2009, it was disclosed that this lender had fired its chief credit officer. This information could have been referred to the Philadelphia HOC for an in-depth review of loans underwritten by the lender during this employee's tenure.

[2] Lender names and other identifying information were redacted (deleted) from the report.

Example D - Boise, ID, Jurisdiction

In a letter, dated September 1, 2009, the lender advised Lender Activities that it had terminated the employment of an appraiser and two loan officers who were involved in 30 percent of its early defaulted loans that were cited in the proposed termination letter. This information could have been shared with the Denver HOC to determine whether an in-depth review of the loans appraised and originated by these individuals was warranted. An in-depth review may have resulted in recommendations leading to improved lender operations, indemnification of loans, other administrative sanctions, and/or referral to the HUD OIG.

Example E - New York, NY, Jurisdiction

The QAD analyst's summary in the case file states that a specific individual was the "manual underwriter" for 35 of the 80 early defaulted loans reported on the March 31, 2009, Credit Watch report. The individual identified was also the president of the lender. If the Philadelphia HOC had been sent a list of these loans and a copy of the QAD analyst's report, an in-depth review of the loans underwritten by this individual could have been conducted to determine whether indemnification of loans, other administrative sanctions, and/or a referral to the HUD OIG was warranted.

The Director of Lender Activities advised us that the Credit Watch program is strictly a statistical function; separate from the in-depth reviews performed by the HOCs, and is just one part of HUD's overall lender oversight efforts. The QAD stated that Credit Watch information is communicated with the HOCs during the informal hearing process and factored into targeting lenders for the in-depth reviews; however, it was not evident in the documentation that we reviewed. We believe that a more coordinated approach and integration of the Credit Watch review and analyses with other oversight efforts would further strengthen HUD's risk management of deficient lender loan performance.

Observation 3: Credit Watch Policies and Records Were Incomplete

QAD's operation of the Credit Watch program generates and collects documentation for each successive Credit Watch round. QAD has a written policy for drawing down the Credit Watch reports and updating HUD's databases with its termination actions but does not have written policies for postponing (holding) proposed terminations, withdrawing actions once terminations are proposed, or creating and maintaining a complete historical record.[3] Further, adequate documentation supporting management's decisions to postpone termination actions was not always evident in the QAD case files.

Lack of formal policies for postponing and withdrawing proposed termination actions may result in inconsistent/inappropriate determinations. Absent a complete record of the deliberative

[3] GAO/AIMD-00-21.3.1, November 1999. Under GAO's Standards for Internal Control in the Federal Government, all significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained.

process (i.e., information considered, discussions held, decisions made) used to determine whether to postpone a proposed termination action, increases the risk that not all relevant information was considered. Further, the lack of a complete record makes it difficult for the QAD when asked to provide a basis for the decisions it made during each Credit Watch round.

Postponement or Withdrawal of Proposed Termination Actions

As part of the Credit Watch process, 24 CFR 202.3(c)(2)(iv) states, "after considering relevant reasons and factors beyond the mortgagee's control that contributed to the excessive default and claim rates, the Deputy Assistant Secretary for Single Family Housing or designee may withdraw the termination notice." The regulations also permit the HUD Secretary to not terminate a lender's origination approval agreement and or direct endorsement approval if the Secretary determines that the excessive default and claim rate is the result of mortgage lending in underserved areas.

<u>Postponements (Holds)</u>

QAD management reviews the recommendations for proposed terminations received from its analysts and judgmentally decides to postpone or hold any actions until future quarters. While there are no written procedures for these holds, the QAD stated that the primary reason for postponing proposed termination actions is when lender's have a higher rate of loans originated in underserved census tracks in comparison to other lenders in the same jurisdiction.

Of the 382 lender branches that exceeded the Credit Watch thresholds during the 2-year period ending September 30, 2009, there were 179 holds. QAD stated that it monitors all holds that continue to exceed the Credit Watch thresholds, performing this oversight by obtaining default and claim comparison analysis reports (comparison reports) from Neighborhood Watch for every quarter for which a branch placed on hold still exceeds the thresholds. The comparison reports document QAD's reasons for continuing to hold proposed actions.

For the quarter ending March 31, 2009, there were 31 holds out of 62 potential proposed termination actions. We requested copies of the comparison reports for 5 of the 31 holds, covering Credit Watch quarters June 30, 2009, through March 31, 2010. We wanted to determine whether QAD continued to monitor lender branches with postponed proposed termination actions.

QAD provided the comparison reports for 7 of the 17 applicable Credit Watch quarters. However, it was not able to provide reports or other justification for the remaining 10 quarters, although the lender branches exceeded the Credit Watch thresholds, as shown in the following table.

	HUD office jurisdiction	Default & claim ratios for quarter ending			
		30-Jun-09	30-Sep-09	31-Dec-09	31-Mar-10
Lender A	Houston	223%	276%	401%	455%
Lender B	Kansas City	212%	236%	222%	219%
Lender C	Phoenix	223%	303%	283%	♦
Lender D	Las Vegas	216%	223%	226%	202%
Lender E	Oklahoma City	♦	211%	♦	210%

♦ Not applicable. The lender's default and claim ratio for the quarter did not exceed the Credit Watch thresholds.

□ QAD provided an analysis report for this quarter.

Withdrawals

QAD withdrew the proposed termination actions for 41 of the 203 lender branches that received notices of proposed terminations during the 2-year period ending September 30, 2009. The withdrawal of proposed termination letters sent by HUD to the 41 lenders stated, "HUD/FHA will continue to systematically review the rate of defaults (loans 90 or more days delinquent) and claims on all FHA loans every three months." QAD explained that it continues to monitor withdrawn branches if the branch default/claim rates continue to exceed the Credit Watch thresholds in subsequent Credit Watch quarters. Similar to the postponement of proposed termination actions, QAD obtains the comparison reports from Neighborhood Watch for every quarter for which a lender's branch continues to exceed the thresholds.

For the quarter ending March 31, 2009, there were 6 withdrawals out of 31 proposed termination actions. We requested copies of the comparison reports for four of the six withdrawals covering Credit Watch quarters June 30, 2009, through March 31, 2010. We wanted to determine whether QAD had continued to monitor lender branches for which proposed termination actions had been withdrawn.

QAD could not locate comparison reports for the four withdrawals for the periods requested, although the lenders' branches continued to exhibit excessive default and claim ratios, as shown in the table below.

	HUD office jurisdiction	Default & claim ratios for quarter ending			
		30-Jun-09	30-Sep-09	31-Dec-09	31-Mar-10
Lender 1	New York, NY	404%	421%	418%	♦
Lender 2	Philadelphia	280%	267%	302%	■
Lender 3	Miami	433%	526%	578%	646%
Lender 4	Newark	357%	360%	383%	386%

♦ Not applicable. The lender's default and claim ratio for the quarter did not exceed the Credit Watch thresholds.

■ Not applicable. The MRB withdrew the lender's approval to participate in FHA programs in January 2010.

Incomplete Records

QAD had not established a uniform record-keeping system for staff to follow during the Credit Watch process. Documentation was not secured in case files reviewed and often did not provide a complete historical record. Many instances were found in which case files lacked:

- A clear record of the analyst's recommendation to terminate a branch and/or management's determination for placing proposed termination actions on hold.

- Documentation of final QAD determinations for lender branches which received proposed terminations but either failed to request an informal conference, voluntarily terminated their branch, or were subject to administrative action by the MRB.

Establishing formal policies for proposed termination actions as well as the creation and maintenance of a complete historical record would strengthen and improve the Credit Watch process. In an effort to improve their internal procedures, the QAD advised that they developed a standard form for each Credit Watch case that reflects the QAD staff analyses (e.g., lender information, default and claim cases, monitoring reviews, etc.), notes from the informal hearing, as well has the justification for the final determination. The form also provides for a "Recommendation/Final Decision," and the name and date of the deciding official. QAD also informed us that they are in the process of developing standard operating procedures for the Credit Watch Termination Initiative.

Other Matter

For the quarter ending March 31, 2009, more than 3,000 lender branches were automatically eliminated from further review under Credit Watch by QAD although they had default and claim rates in excess of the 200 percent termination threshold. The eliminations were made because QAD established a de minimis amount of defaults and claims that a lender branch must attain before being subject to the Credit Watch review and analyses for termination. Most of these branches had fewer than 10 defaults and claims, and about 200 of them had between 10 and 24 defaults and claims.

The QAD did not have a formal written policy of the procedures to determine the de minimis amount and did not provide support for the basis of the de minimis amount used. To ensure that the Credit Watch process does not lose its deterrent effect, procedures used for determining the de minimis amount should be formally documented and the basis for the de minimis amount used for each Credit Watch round should be supported.

Recommendations

Going forward, for Credit Watch to be a more effective tool in HUD's overall risk management efforts, the Office of Single Family Housing should ensure that the recent termination procedures are effectively implemented and a coordinated approach is taken to integrate the Credit Watch results with other departmental oversight efforts. Further, standardizing the Credit Watch file documentation and procedures as well as supporting the de minimis amount used by QAD will improve and strengthen the Credit Watch process.

In this regard, we are recommending that HUD's Office of Single Family Housing:

1. Establish a formal process to better coordinate and integrate the Credit Watch process with other departmental oversight efforts, such as the fact-based lender reviews conducted by the HOCs.

2. Formally document the procedures used for postponing (holding) and withdrawing proposed Credit Watch terminations.

3. Establish a uniform record-keeping system that provides for a complete historical record of the Credit Watch process and results, including documenting managements' decisions in the QAD case files.

4. Formally document the procedures for determining the de minimis amount used by the QAD for identifying lenders that are subject to the Credit Watch process and ensure that the basis for the de minimis amount is supported.

Comments and OIG Response

HUD's Office of Single Family Housing's response included in appendix A did not change the reported observations and related recommendations. While the response states they disagree with observations 2, 3, and the other matter, it advises that standard operating procedures to "better manage the implementation of its Credit Watch activities" are under development. We recognize the Office of Single Family Housing's efforts to improve its Credit Watch process. The establishment of standard operating procedures is responsive to recommendations 1 through 4. However, the recommendations remain open pending verification of corrective actions taken.

Appendix A – HUD's Office of Single Family Housing's Comments

OFFICE OF HOUSING

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

SEP 17 2010

MEMORANDUM FOR: Jennifer L. Sorenson, Director, Inspections and Evaluations Division, Office of Investigations, GIH

Joy Hadley

FROM: Vicki Bott, Deputy Assistant Secretary for Single Family Housing, HU

SUBJECT: Discussion Draft – Evaluation of the Effectiveness of HUD's Credit Watch Termination Initiative in Deterring Deficiencies in the Performance of Lenders' Loans

This is in response to your memorandum dated September 1, 2010, transmitting the subject draft evaluation report.

In its report, the Office of Inspector General (OIG) stated that the Credit Watch Termination Initiative (Credit Watch) statistical reports effectively identified lender branch offices with unacceptably high default and claim rates for loans originated within the preceding 24 months. OIG maintained that for Credit Watch to be a more effective tool in HUD's overall risk management efforts, Single Family Housing (Housing) should ensure Credit Watch results are integrated with other oversight activities and should standardize Credit Watch file documentation and procedures. Housing's comments to the draft evaluation are outlined below.

Credit Watch Results Could Benefit Other Oversight Efforts

In its evaluation report, the OIG stated that "the information obtained during the Credit Watch process is not routinely shared or coordinated with the departmental oversight efforts". Housing strongly disagrees with this observation. All significant information discovered throughout the Credit Watch process is routinely shared with the Homeownership Centers (HOCs). As stated on the draft report, copies of all proposed action and final determination letters are provided to the HOC's. In addition, significant information is shared with the HOC QA Divisions during monthly and quarterly meetings. Furthermore, Housing integrates intelligence obtained during Credit Watch activities into its lender monitoring targeting methodology. It should also be noted that the lender targeting list is constantly revised and updated during the fiscal year to address emerging risk trends and feedback from the HOCs.

Notwithstanding, in an effort to create greater standardization among its procedures, QAD is currently developing Standard Operating Procedures to better manage the implementation of its Credit Watch activities.

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Credit Watch Policies and Records Were Incomplete

The OIG stated that Housing lacks formal policies for postponing and withdrawing proposed termination actions, which may result in inconsistent/inappropriate determinations. Housing disagrees with this assertion. Housing's established processes to review and analyze proposed terminations include provisions to examine lenders "held" and withdrawn on previous performing periods. All FHA-approved lenders are subject to Credit Watch examination quarterly. Housing's QAD completes the analysis using statistical data extracted from the Early Warnings Neighborhood Watch System. For cases where there is sufficient documentation to support postponing the Credit Watch termination action, the analysis is filed, and the decisions are recorded in QAD's Credit Watch tracking documents. As a matter of procedure, those lenders are re-evaluated in subsequent performing period(s).

Similarly, withdraw actions are decisions based on written documentation provided by the lenders, discussion at the informal conference and analysis of mitigating factors. These decisions are documented in each case file.

As previously stated, in an effort to create greater standardization among its procedures, Housing's QAD is currently developing Standard Operating Procedures for its Credit Watch activities.

Other Matter

The OIG stated that QAD did not have formal written policy of the procedures to determine the de minimis amount of default and claims that a lender branch must attain before being subject to the Credit Watch review. Housing disagrees with this observation. The de minimis amount of loans is established at the beginning of the evaluation process, and it is based on the number of egregious offenders and available resources. While this information is not published, it is documented in the corresponding performance period files. This process will also be clarified on the Credit Watch termination Standard Operating Procedures.