Issue Date June 14, 2011	
Audit Report Number 2011-KC-0001	

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

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

SUBJECT: FHA Has Improved Its Annual Lender Renewal Process, but Challenges Remain

HIGHLIGHTS

What We Audited and Why

We audited the Federal Housing Administration's (FHA) Title II single-family lender renewal process. During our 2009 audit of FHA's lender approval process, we noticed indications of weaknesses in the controls over FHA's process to annually renew lenders' status as FHA-approved lenders. Our objective was to determine whether the Lender Approval and Recertification Division's (Division) controls were adequate for determining whether lenders met FHA annual renewal requirements.

What We Found

The Division had taken significant steps to strengthen its controls over the lender renewal process; however, additional improvements are needed. The process still had weaknesses related to Mortgagee Review Board referrals, lender financial information review, and data and renewal fee calculations in the Division's lender recertification tracking system. These weaknesses resulted in an increased risk that noncompliant lenders were allowed to continue participating in the FHA program, the Division's inability to effectively monitor lenders, and lenders paying lower fees than required.

What We Recommend

We recommend that the Deputy Assistant Secretary for Single Family Housing require the Division to improve controls over the lender recertification process and make changes to the Institutional Master File system to ensure data integrity.

Auditee's Response

We provided the discussion draft to the U.S. Department of Housing and Urban Development (HUD) on April 1, 2011, and requested a response by May 2, 2011. HUD provided a response on May 19, 2011. HUD generally agreed with finding 1 and parts of finding 2 but disagreed with some of our recommendations. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

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 mortgages. 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 HUD (U.S. Department of Housing and Urban Development) Reform Act of 1989, 12 U.S.C. (United States Code) 1708 established the Mortgagee Review Board and 24 CFR (Code of Federal Regulations) Part 25 outlines its duties and procedures. The Mortgagee Review Board consists of HUD officials, including the Assistant Secretaries of Housing and Fair Housing as well as key legal and finance personnel. The President of the Government National Mortgage Association is also a member of the board. FHA-approved lenders who knowingly and materially violate FHA program statutes, regulations, and handbook requirements are subject to administrative sanctions and civil monetary penalties by the Mortgagee Review Board. The Mortgagee Review Board meets monthly to rule on actions to be taken against noncompliant lenders.

Lender Approval and Recertification Division

The Lender Approval and Recertification Division (Division) is responsible for reviewing renewal items and referring noncompliant lenders to the Mortgagee Review Board for possible sanctions. The Division begins this legal process by preparing notices of violation for the Mortgagee Review Board. The Office of Lender Activities and Program Compliance oversees the Division.

The HUD Administrative Proceedings Division of the Office of Associate General Counsel for Program Enforcement (Office of Program Enforcement) provides affirmative counsel, guidance, and support to the Division. In Mortgagee Review Board actions, attorneys evaluate potential cases for legal sufficiency and litigate cases on behalf of the Government.

Before 2008, the Division had authority to withdraw lenders for failure to comply with FHA's annual renewal requirements. The Division lost this authority due to a 2007 administrative hearing ruling (HUDALJ 07-052-MR). 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 administrative law judge ruled that the lender was not given due process.

Significant Changes in Statutes and Regulations That Affected the Division

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

- Mortgagee Letter 2009-01, dated January 6, 2009, informed lenders that if they failed to complete the renewal requirements in an acceptable, timely manner, they might be brought before the Mortgagee Review Board.
- 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, dated September 18, 2009, implemented the Helping Families Save Their Homes Act of 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.

On April 20, 2010, HUD published the final rule change for the lender approval and renewal process. The final rule eliminated FHA approval of loan correspondents, increased the net worth requirements for FHA-approved lenders, codified requirements of the Helping Families Save Their Homes Act of 2009 (Public Law 111-22), and made minor modifications to other aspects of FHA's regulations governing lender activities.

Requirements for Maintaining Status as an FHA-Approved Lender

To maintain status as an FHA-approved lender, lenders must electronically submit a yearly certification and pay an annual fee for their main and registered branch offices. This action had to be completed within 30 days of the lender's fiscal yearend date. The date when this information is submitted is recorded in the Institutional Master File. The Institution Master File maintains the official record of lenders approved by FHA to originate, service, or invest in FHA-insured mortgages or loans. One of the principal objectives of the Institutional Master File is to consolidate information on the approval status of mortgagees and lenders participating in FHA's insurance programs.

Nonsupervised mortgagees were required to electronically submit annual audited financial statements and required reports that meet the requirements of the Secretary of HUD within 90 days of the lender's fiscal yearend date. On November 17, 2010, FHA issued Mortgagee Letter 2010-38, which immediately changed the 30-day requirement for the certification and fees to 90 days. In addition, as discussed in Mortgagee Letter 2009-31, supervised mortgagees must submit audited financial statements to HUD beginning with the 2010 calendar year.

The lender's financial statement reporting package is submitted electronically through the Lender Assessment Subsystem. This system automatically triggers flags if the data in the reporting package violates established requirements. Lender reporting packages that trigger flags require a manual review. Lender reporting packages that do not trigger flags are automatically approved by the system without review by the Division.

Our audit objective was to determine whether the Division's controls were adequate for determining whether lenders met FHA annual renewal requirements.

RESULTS OF AUDIT

Finding 1: Control Weaknesses in FHA's Lender Renewal Process Continued To Impact Lender Oversight

FHA had weaknesses in its controls for determining whether lenders met their annual renewal requirements. This condition occurred because the Division could not establish effective controls quickly enough to keep pace with rapid internal and external business changes. As a result, the Division was less able to effectively monitor and assess the condition of the lenders and determine whether they posed a risk to HUD, its programs, or the public.

FHA Had Improved Its Controls, but Weaknesses Remained

FHA and the Division recently made significant changes that strengthened controls over the lender renewal process, including

- Requiring lenders to submit the annual certification electronically;
- Requiring each lender to register the names of the corporate officers who make its electronic annual renewal certifications;
- Adding new flags to the Lender Assessment Subsystem to identify lender financial statement deficiencies; and
- Sending lenders automated 60-, 30-, and 15-day e-mail reminders before the annual renewal due date.

These changes, along with eliminating the FHA approval of loan correspondents, improved the effectiveness and efficiency of the lender renewal process.

However, there were still some weaknesses in the process. Specifically, the Division

- Did not have written procedures for referring lenders to the Mortgagee Review Board,
- Did not have a reliable way to flag high-risk lenders for manual reviews,
- Did not have an effective method for ensuring the accuracy of lender financial data in the Lender Assessment Subsystem, and
- Did not include a notification of potential penalties in the lender's financial statement certification.

According to Office of Management and Budget (OMB) Circular A-123, management control is an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

effectiveness and efficiency of operations, reliability of reporting, and compliance with applicable laws and regulations. Management control activities include policies, procedures, and mechanisms in place to help ensure that agency objectives are met.

The Division Lacked Written Procedures for Referring Lenders for Sanctions

The Division did not have written procedures for referring lenders to the Mortgagee Review Board. With assistance from the Office of Program Enforcement, the Division developed informal policies and procedures for referring lenders that violated annual renewal requirements to the Mortgagee Review Board. This measure resulted in a process through which the Division conducted roundtable discussions to determine, on a case-by-case basis, which lenders are referred to the Mortgagee Review Board for sanctions, the recommended amount of civil money penalties assessed, and whether the lender should be terminated.

This process did not always result in referring lenders that violated renewal requirements to the Mortgagee Review Board for sanctions, nor was the reason for not making those referrals apparent. A sound control system should include written procedures with predetermined actions to consistently guide the Division in making decisions about referring lenders to the Mortgagee Review Board.

The Division Did Not Consistently Flag High-Risk Lenders for Review

The Division did not have a reliable method for flagging high-risk lenders for manual reviews. The Lender Assessment Subsystem Standard Operating Procedures states that the Division will manually enter flags for high-risk lenders so that their financial statements will be manually reviewed. High-risk lenders are typically new or high-volume lenders or those that have experienced some types of past problems. However, more than 124 high-risk mortgagees with October 2008 through September 2009 fiscal yearends were not flagged for manual review.

The Division was in the process of linking the Lender Assessment Subsystem with other systems containing lender data to automate the process of flagging high-risk lenders. However, we were unable to review the effectiveness of this improvement since it was not completed during our audit.

The Division's Controls Over the Accuracy of Lender Data in Its System Were Not Effective

The Division did not have an effective method for ensuring the accuracy of lender information in the Lender Assessment Subsystem. Each lender is responsible for entering its financial statement information into the Lender Assessment Subsystem. The lender's independent public accountant is responsible for verifying that the information was entered accurately (appendix D). However, Lenders often entered inaccurate information into the Lender Assessment Subsystem data collection form for the financial statements (appendix C), and the independent public accountants did not identify that the data in this form was inaccurate.

The Division's contracted quality assurance auditors had also reported that lenders entered inaccurate financial information into the Lender Assessment Subsystem data collection form. They sampled a total of 436 lenders, the financial statements of which were auto-accepted by the Lender Assessment Subsystem, and found that more than 60 percent of these financial statements would have required correction before being accepted. The contracted auditors projected this percentage to the universe and determined that 2,657 of the 4,322 lender financial statements auto-accepted by the Lender Assessment Subsystem were deficient.

The Division was improving the Lender Assessment Subsystem to better analyze data and create new flags in the system and planned to impose sanctions on independent public accountants that were responsible for verifying the information in the system. These are significant improvements. However, they alone will not adequately ensure that the financial statement data form information is accurate. The improvements will need to include a comparison of the data in the system to contents of the actual audit reports, financial statement footnotes, and audit findings.

The Lender's Financial Statement Certification Needs Strengthening

The Division did not include a notification of potential penalties in the lender's financial statement certification (appendix D).

The current certification states:

> This is to certify that to the best of my knowledge and belief, the information contained in this submission – including but not limited to the

> accompanying FDT [Financial Data Template], DCF [Data Collection Form], and Notes & Findings – is accurate and complete for the period …. By selecting Submit, I declare that the foregoing is true and correct.

A notification of potential penalties included with this certification would strengthen the Division's controls by ensuring that lenders are aware of the consequences of submitting inaccurate or incomplete data.

The Division Had To Adapt to Internal and External Business Changes

The Division could not establish effective controls quickly enough to keep pace with rapid internal and external business changes. When FHA lost the 2007 administrative hearing, it had to change the way that it took actions against lenders and create new policies and procedures. Before the administrative hearing, the Division could withdraw lenders that violated annual renewal requirements and reinstate these lenders when they became compliant. Now these lenders must be sent to the Mortgagee Review Board for administrative action. This requires a legal process that involves more resources. In addition, during this period, FHA named a new director of the Division and a new recertification branch chief. Further, there was a shortage of trained staff to review the financial statements and lender responses to financial statement deficiencies.

There were also a number of external business changes. There was a large increase in the number of approved FHA lenders and, as reported in our prior audit report (2010-KC-0002, issued August 6, 2010), more than half of the lenders violated annual renewal requirements. Additionally, there were a number of changes in FHA statutes and regulations to strengthen FHA's risk management. For example, Mortgagee Letter 2009-25 requires lenders to submit annual recertifications electronically and to provide the names and Social Security numbers of the officials that enter the electronic certifications on behalf of each lender. The Mortgage Letter provides that FHA will validate the required Social Security numbers. Additionally, the Helping Families Save Their Homes Act of 2009 contains provisions that provide limitations on those eligible to participate in FHA programs.

The Annual Renewal of FHA Approval Requirements Is Critical to the Program

As noted in Mortgagee Letter 2009-01, HUD considers the timely annual renewal of FHA approval requirements to be critical to its ability to adequately monitor and assess the condition of the lender and determine whether the lender poses a risk to HUD, its programs, or the public. We agree.

A lack of written policies and procedures for the annual renewal process can create inconsistencies in the treatment of noncompliant lenders. By not flagging high-risk lenders for manual reviews, the Division cannot be assured that it is devoting its monitoring resources in the highest risk areas. Inaccurate data in the Lender Assessment Subsystem inhibit effective assessments of lenders' financial condition. And, without a notification of potential penalties in the lender's financial statement certification, lenders will be less likely to be deterred from submitting false data, and HUD will be less likely to prevail in enforcement actions against lenders that submit false data.

All of the above factors contributed to the Division's being less able to effectively monitor and assess the condition of the lenders and determine whether they pose a risk to HUD, its programs, or the public.

Conclusion

Although the Division had made substantial improvements in controls over the annual recertification process, additional improvements are needed to ensure that lenders meet FHA eligibility requirements. The Division needs to adopt written procedures to ensure that lenders that violate annual renewal requirements are properly referred to the Mortgagee Review Board and are treated consistently. Controls relating to lender financial statement information need to be improved to ensure proper review of information received from high-risk lenders and to detect incorrect financial information in the Lender Assessment Subsystem. Financial information certifications need to be strengthened to discourage lenders from misrepresenting financial data in the Lender Assessment Subsystem. Establishing stronger controls and deterrents will ultimately reduce the workload of the Division and will reduce the risk to the FHA insurance fund.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing require the Division to

1A. Improve controls over the lender recertification process by
- Preparing and implementing written procedures containing benchmarks for determining which noncompliant lenders should be referred to the Mortgagee Review Board for sanctions,
- Preparing and implementing written procedures to ensure that high-risk lenders' financial statements are manually reviewed,
- Preparing and implementing procedures to ensure that the data in the Lender Assessment Subsystem are accurate and complete, and
- Adding a notification of potential penalties for false certification to the financial statement certification.

Finding 2: Data and Lender Fee Calculations in the Division's Recertification Tracking System Were Not Always Accurate

The Division's system used to keep track of lenders' annual renewal progress contained data and lender fee calculations that were not always accurate. This condition occurred because the Division did not develop sufficient controls to ensure data integrity. As a result, the Division could not accurately monitor the renewal status of lenders, and lenders paid lower fees than required.

Inaccurate Data Existed in the Division's System

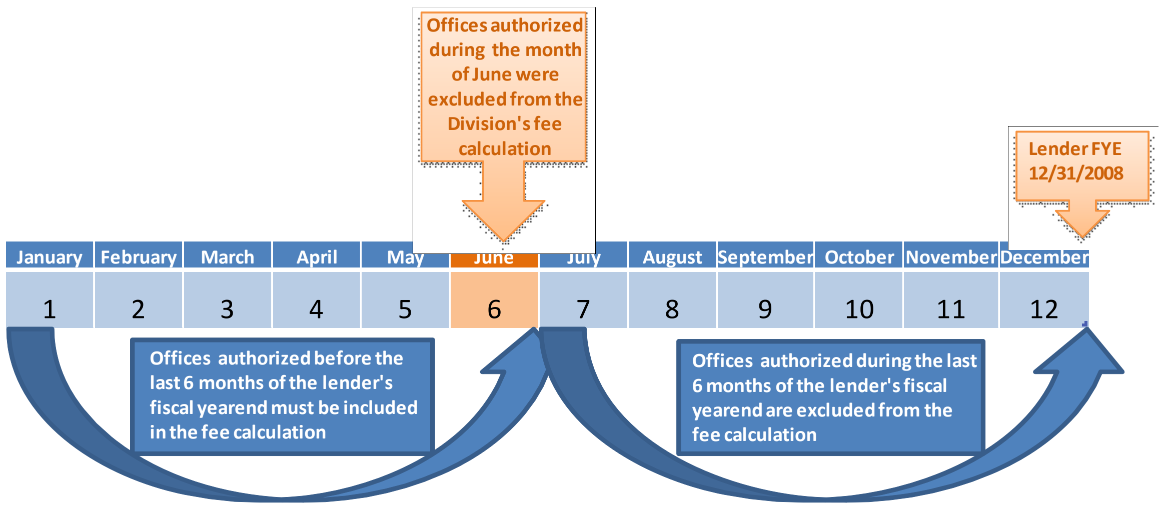
The dates and status codes in the Institution Master File system (System) were not always correct. This system was used by the Division to track each lender's progress in the annual renewal process. The System contained annual renewal data including the status and date submitted for the annual certification, renewal fee, and audited financial statements. The System's status and date information was not always accurate. For example,

- The System incorrectly showed 690 lenders with a "received" status for their annual certification and a "paid" status for their renewal fee. The receipt date in the system for the certification and fee payments was December 26, 2008. The Division told us that these lenders did not actually make a fee payment on that date because the fee was not owed. However, instead of entering a "not owed" status into the system for these lenders, the fee status was incorrectly reset to "paid" with a receipt date of December 26, 2008.

- The System showed conflicting status codes for 116 lenders. For these lenders, the system's status code showed "new approval/reinstatement" for one or more of the required renewal items and a status code of "owed," "received," or "paid" for the other renewal items. If these lenders were actually reinstated or newly approved during the year, at least one of the status codes was not accurate since the renewal items would not have been due. If the lender was not newly approved or reinstated, the "new approval/reinstatement" code should not have been used.

Lender Fees Were Not Calculated Correctly

The System did not correctly calculate annual renewal fees for 458 lenders that added offices in the seventh month before their yearend. According to HUD Handbook 4060.1, REV-2, each lender was required to pay $500 for its main office plus $200 for each branch registered for more than 6 months before its fiscal yearend date. For its fee calculation, the System captured only the lender's yearend month and subtracted 6 months. For example, if a lender's fiscal yearend month was December, the System used June for the branch cutoff date. However, the lender's yearend date was actually December 31, so the sixth month cutoff date should have been July 1. Consequently, 266 main offices and 385 branches were incorrectly omitted from the fee calculation. The following graph depicts the date error for lenders with a December 31 yearend.



In addition, the System did not have a built-in cutoff date for lenders to delete branches. Before paying the annual renewal fees, 217 lenders were able to delete 973 branches in the System, although the branches were active beyond their previous fiscal yearend date.

The Division Did Not Develop Sufficient Controls

The Division did not develop sufficient controls to ensure data integrity and reliable data processing. It relied solely on the System to collect renewal data and calculate the renewal fees without verifying that the data were accurate. In addition, it did not perform testing of the payment calculation to determine whether the System computed the correct amount of fee.

According to OMB Circular A-123, information systems controls should be designed to ensure that the data are valid and information processing is accurate. Further, HUD Handbook 1840.1 states that management controls are vital and must be in place to ensure that automated data processing is reliable.

The Division was modifying its systems. However, the changes had not been implemented in time for review.

The Division Could Not Accurately Monitor Lenders

To enforce renewal requirements, the Division must be able to efficiently monitor lender compliance. If a lender's status in the System did not accurately reflect its renewal progress, the Division would not be able to readily determine whether the lender still owed a renewal item. Consequently, lenders could actively conduct FHA business without submitting the required renewal items.

For example, a lender originated FHA mortgages without submitting its certification and fee because the System reported a status of satisfied instead of an "owed" status for all of the requirements. However, at that time, only the financial statements had been submitted, but the form and fee had not.

Lenders Paid Lower Fees Than Required

The data system issues allowed lenders to pay lower fees than required. FHA lenders with fiscal years ending October 1, 2008, through September 30, 2009, paid $404,600 less than they should have. The date error omitted 1 month's worth of lender branches, accounting for $210,000 in lost fees. The lenders' ability to delete branches after the payment was due resulted in an understatement of $194,600 in fees. The Scope and Methodology section shows the calculation of these amounts.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing require the Division to

2A. Make changes to the System to ensure that

- The data accurately reflect the status of each lender's recertification,
- The fee payment calculation includes each branch registered for more than 6 months before its fiscal yearend date,
- The system has a built-in cutoff date for lenders to delete branches, and
- An estimated $178,600 in future fees collected from mortgagees can be available for the purposes of the FHA single family insurance program. The calculation for the $178,600 is provided in the Scope and Methodology section.

2B. Collect $210,000 in underpaid fees from the 458 lenders that added offices in the seventh month before their yearend that were not used in the fee calculation and $194,600 from the 217 lenders that were able to delete 973 branches in the System that were active beyond their previous fiscal yearend date. The calculation of the unpaid fees is provided in the Scope and Methodology section. We will provide a list of these lenders to the Division.

SCOPE AND METHODOLOGY

This audit is the second of two audits of FHA's lender renewal process. During our initial audit, we noticed indications of weaknesses in the controls over the lender renewal process. Our audit covered 11,163 Title II lenders with October 2008 through September 2009 fiscal yearends that were required to submit annual recertification items. We expanded our scope as necessary. We conducted our fieldwork from October 2009 through November 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;
- Evaluated the Division's manuals, quality control plan, and certification;
- Examined Mortgagee Review Board meeting documents; and
- Analyzed lender data contained in the Single Family Housing Enterprise Data Warehouse, Institutional Master File system, and the Lender Assessment Subsystem.

We gained an understanding of the lender recertification process and procedures by interviewing HUD staff and reviewing the laws and regulations affecting FHA lender annual recertification. We examined the annual renewal and financial statement certifications to determine whether they complied with requirements and compared them to the lender approval certification. We evaluated the Division's quality control plan, Lender Assessment Subsystem Standard Operating Procedures, and manual. We used lender data found in the Single Family Housing Enterprise Data Warehouse to identify high-risk lenders as defined in the Lender Assessment Subsystem manual. We compared the high-risk lenders with the list of lenders provided by the Division that were automatically approved through the Lender Assessment Subsystem. We also identified high-risk lenders with deficient net worth and/or liquidity.

We relied on work performed by the Division's quality assurance auditors. The auditors worked for a certified public accounting firm, and the work performed was compliant with generally accepted government auditing standards. We evaluated the quality assurance auditors' qualifications and reviewed their quality assurance reports. The quality assurance auditors selected a random sample of lenders' financial statements that auto-completed through the Lender Assessment Subsystem to determine whether the financial statements complied with FHA requirements. We reviewed a sample of the lenders audited financial statements and agreed with the quality assurance auditor's opinion. The work done by the quality assurance auditors was sufficiently reliable to satisfy our audit objective.

We evaluated the amount of the annual renewal fees associated with October 2008 through September 2009 fiscal yearend lenders. The Division provided lender amounts paid and due from the Institution Master File, and we obtained data from the Single Family Housing Enterprise Data Warehouse to analyze the fees calculated by the Institution Master File system. We also requested the programming code used for the fee calculation. We determined what the fee calculation should be and the lender branches that were omitted because of the fiscal yearend date error based on the regulations. There were 385 branches and 266 offices omitted from the fee payments. With a $200 per branch fee and a $500 per office fee, the Division did not collect $210,000 in annual fees ((385 x $200) + (266 x $500)).

We then quantified how many branches were left out of the fee calculation because a cutoff date was not established for branch deletion by using the authorized date, termination date, and fiscal yearend of the lenders and their branches. There were 973 lender branches terminated after the fee due date but before the late payment was made. At $200 per branch, the Division did not collect $194,600 (973 x $200).

To estimate the amount of funds to be put to a better use, we removed the amounts in the 2 calculations above that were associated with loan correspondents because only mortgages will be required to register in the future. For the mortgagees, there were 269 branches and 28 offices omitted from the fee payments. With a $200 per branch fee and a $500 per mortgagee office fee, the Division did not collect $67,800 ((269 x $200) + (28 x $500)). Additionally, for the mortgagees there were 554 branches terminated after the fee due date but before the late payment was made. At $200 per mortgagee branch, the Division did not collect $110,800 (554 x $200). We used the sum of these amounts as our estimated $178,600 funds to be put to better use in Appendix A.

We assessed the reliability of the Lender Assessment Subsystem and Institution Master File data by performing electronic testing for erroneous and incomplete data. The Institution Master File system contained inaccurate data as reported in finding 2, and the Lender Assessment Subsystem contained duplicate records. We removed those discrepancies, such as inaccurate submission status and dates and inconsistencies between the recertification items, from the data before our analysis. We did not assess the reliability of the Single Family Housing Enterprise Data Warehouse data as the data were used solely 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 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 management 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 objectives:

- Policies and procedures for the annual renewal process.
- Effective system controls for certifications, fee payments, and lender financial reporting packages.
- Lender certifications.
- Management reporting for monitoring the annual renewal process.

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 Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The Division lacked written procedures for referring lenders to the Mortgagee Review Board and lacked adequate controls over the review of lender audited financial statement packages (finding 1).

- The Division did not develop sufficient controls in the Institutional Master File system to ensure data integrity and reliable data processing (finding 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
2A		$178,600
2B	$404,600	

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. For this instance, this is the amount of additional future fees that will be collected if the Division implements our recommendations. The calculation of this amount is described in the Scope and Methodology section of the report.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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

OFFICE OF HOUSING

MAY 19 2014

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 Annual Renewal Process II

The Office of Inspector General (OIG) performed an audit of the Federal Housing Administration's (FHA) Single-Family Lender Recertification Branch to determine whether adequate controls and procedures existed to ensure that FHA-approved lenders meet its renewal requirements.

The OIG asserts that FHA could not establish effective controls quickly enough to keep pace with rapid internal and external business changes. Additionally, the OIG contends that the Lender Approval and Recertification Division's (LA&RD) internal renewal tracking system contained data and lender fee calculations that were not always accurate. According to the OIG, these conditions reduced LA&RD's ability to monitor renewal statuses and assess the condition of lenders to determine whether they posed a risk to HUD, its programs or the public, and allowed lenders to pay lower fees than required.

Comment 1

The Office of Lender Activities and Program Compliance (OLAPC) appreciates the seriousness of the OIG's review and is grateful for the opportunity afforded by these examinations to evaluate and enhance OLAPC's practices and policies. LA&RD is one of OLAPC's three Divisions. Prior to receipt of this report, many improvements suggested by OIG had already been initiated by LA&RD. OLAPC notes that OIG acknowledged in its report the improvements made during the audit. Looking forward, OLAPC is confident in its capacity to continue improving its processes and to keep pace with business changes as they arise.

OLAPC has thoroughly reviewed OIG's recommendations and offers the following responses to each of the recommendations set forth in the report:

Recommendation No. 1A

Improve controls over the lender recertification process by:

- Preparing and implementing written procedures containing benchmarks for determining when noncompliant lenders should be referred to the Mortgagee Review Board (MRB) for sanctions and/or civil money penalties;
- Preparing and implementing written procedures to ensure that high risk lenders' financial statements are manually reviewed;
- Preparing and implementing procedures to ensure that the data in the Lender Assessment

Ref to OIG Evaluation **Auditee Comments**

Subsystem (LASS) is accurate and complete; and

- Adding a notification of potential penalties for false certification to the financial statement certification.

FHA Response

"[Prepare and implement] written procedures containing benchmarks for determining when noncompliant lenders should be referred to the Mortgagee Review Board for sanctions and/or civil money penalties."

OLAPC proposes that the OIG revise its recommendation that written procedures be "prepared and implemented" because written procedures were in place during the audit. OLAPC continually reviews and strengthens its Standard Operating Procedures (Procedures) to ensure that they are current with policy initiatives and changes. Furthermore, OLAPC is sensitive in its approach to how it handles specific cases of noncompliant lenders. In addition to consistent use of OLAPC Procedures, OLAPC recognizes the unique aspects of individual cases that must be taken into consideration as appropriate.

Comment 2

The Lender Recertification Branch's Procedures dealing solely with the referral to the MRI were provided to OIG during its examination. These Procedures are part of recently expanded and more thorough Procedures which encompass all of the Lender Recertification Branch's functions from submission of financial statements through referral to the Mortgagee Review Board and post referral follow up. These enhanced Procedures outline the referral timeline to the MRB.

"[Prepare and implement] written procedures to ensure that high risk lenders' financial statements are manually reviewed."

Comment 3

OLAPC closely monitors high risk lenders including performing manual reviews of their financial statements. In anticipation of the drastic reduction in the number of FHA-approved lenders as a result of final rule FR 5356-F-02 (24 C.F.R. § 202), "Federal Housing Administration: Continuation of FHA Reform – Strengthening Risk Management through Responsible FHA-Approved Lenders," LA&RD has begun the process of implementing a more in-depth review of al lenders. Several new lender risk flags have been added to the Lender Assessment Subsystem (LASS) to target those lenders with the potential to pose the greatest risks to HUD:

- Performance Review Flag – This flag is assigned to a lender by the LASS automated reviev if the lender is on the Risk-Based Targeting List. This is a list of 200 lenders that:
  - (1) have the highest National Compare Ratio (the percentage of originations seriously delinquent or claim terminated divided by the percent of originations seriously delinquent or claim terminated nationwide) and;
    have greater than 100 total loans originated by institution for its previous fiscal yeai
    or
  - (2) are lenders that are specifically identified by OLAPC as requiring special attention (e.g. lenders on the "Credit Watch" list).
- Auto-Completion Alert – This flag is assigned to a lender by the LASS automated review i the lenders' renewal submissions from the two preceding years have been approved througl

Ref to OIG Evaluation	Auditee Comments

the automated review without a manual review by LA&RD staff.

- First-Time Submitter Alert – This flag is assigned to a lender if no submission exists for the prior fiscal year.
- Prior Year Adjusted Net Worth Alert – This flag is assigned to a lender when current year "Net Worth" falls below prior year submission.
- Administrative Review Flag – This flag can be added to a lender by LA&RD staff members in Level 2 and Level 3 reviewer positions and allows them to flag a submission for review that, based on their experience, appears to require additional scrutiny.

In addition, for the period covered by the subject audit, over 2,000 submissions were manually reviewed by LA&RD staff. Lenders considered "high risk" may have been included in that number. OLAPC would like to restate the point that the audit fails to consider the 2007 ruling by the Administrative Law Judge that drastically changed its administrative processes. OLAPC's ability to adapt to these changes and the tremendous strides it has made to confront the resulting backlog should not go unnoticed.

Comment 4

"[Prepare and implement] procedures to ensure that the data in the Lender Assessment Subsystem are accurate and complete."

OLAPC does not control the data entered into LASS. The data entry function is performed by the lender and is based on a paper copy of the audited financial statement prepared by an independent public accountant (IPA). All audited financial statements submitted to LASS for recertification are subject to the IPA's attestation, as well as lender's review. Ideally, any anomalies, omissions, or errors contained in the LASS Financial Data Template would be identified by the IPA.

The LASS automated review assigns any of 30 or more deficiency flags to financial statements. Financial statements flagged during this process are subject to three levels of review by Lender Recertification staff for sufficiency. Any missing, inaccurate or unsupported financial information discovered by staff members would require additional documentation and support prior to acceptance.

The OIG report referenced an audit of LASS conducted by Key & Associates, P.C. It was a review of submissions that were approved through the LASS automated review (auto-complete) process. Key & Associates, P.C. in its report on a sample of 436 auto-completed submissions indicated that 60% of those submissions contained inaccurate financial information and would have been found unacceptable during a manual review. A review of the quality assurance report reveals that of the deficiencies discovered:

- twenty percent failed to use Generally Accepted Government Auditing Standards as a criteria for the audit;
- nine percent did not issue a major compliance report;
- eight percent did not include a hand signed audit report;
- four percent failed to include a complete list of programs tested in the scope of the Major Compliance Report; and
- three percent did not include adequate footnote disclosures.

3

Ref to OIG Evaluation **Auditee Comments**

OLAPC acknowledges that it would not have accepted these audits upon manual review; however, the deficiencies in the audits were not related to the lenders' actual financial standing, but instead were related to the manner in which the data was reported. These instances of non-compliance may be attributed to carelessness on the part of an IPA. Furthermore, the deficiencies posed no immediate threat to the public or the FHA insurance fund.

Comment 5

"[Add] a notification of potential penalties for false certification to the financial statement certification."

Although lenders and their IPAs are aware that penalties will be incurred for submission of any false certification to the audited financial statements. OLAPC agrees with OIG's suggestion that including a clear statement of potential penalties would serve to strengthen OLAPC's controls over the submission of financial data.

The following certification has been drafted and, upon approval, is scheduled to be included in LASS at the next system update:

> *By selecting "Submit," I certify that, to the best of my knowledge and belief, the information contained in this submission – including but not limited to the accompanying Financial Data Template, Data Collection Form, and Notes & Findings – is accurate and complete for the period described on data element lines G2000-010, G2000-020, and G2000-030. I understand that if I knowingly have made or entered any false, fictitious, fraudulent statement(s), representation(s), or data I may be subject to administrative, civil, and/or criminal penalties including debarment, fines, and imprisonment under applicable federal law.*

<u>Recommendation No. 2A</u>

Make changes to the system to ensure that:

- The data accurately reflect the status of each lender's recertification;
- The fee payment calculation includes each branch registered for more than 6 months before the lender's fiscal year end date;
- LASS has a built-in cutoff date for lenders to delete branches; and
- An estimated $178,600 in future fees collected from mortgagees will be made available for the purposes of the FHA Single Family insurance program. The calculation for the $178,600 is provided in the Scope and Methodology section.

<u>FHA Response</u>

"Make changes to the System to ensure that the data accurately reflect the status of each lender's recertification."

OLAPC maintains that the recertification data housed within the Institution Master File (IMF) is accurate. OIG's interpretation of the status codes for recertification requirements does not acknowledge LA&RD's internal policies regarding new approvals and reinstatements. During the approval process, lenders are required to pay an application fee and complete a certification. If the

4

Ref to OIG Evaluation	Auditee Comments

reinstatement or approval takes place within six months prior to its renewal, those items are considered to be received for recertification purposes. Recertification requirements are only marked as "not required" in the period between approval and the first recertification.

In its report, OIG indicated that IMF showed "conflicting" status codes if newly approved or reinstated lenders have a status of "owed" for one or more recertification requirements and "new approval/reinstatement" for others. Upon review of the supporting information received from OIG, OLAPC determined that the "new approval/reinstatement" code was attributed to these lenders by the Lender Approval staff based on internal policies and procedures. As stated above, a lender approved within six months of its fiscal year end is not required to pay a recertification fee or submit an online certification (formerly verification form). Any conflicts found in the data presented to OIG for the purposes of this audit were the result of the verbiage used to reflect the codes in IMF.

Comment 6

OLAPC would like OIG to remove this recommendation from the final audit report as this error was limited and a corrective action plan is in place to prevent reoccurrence.

"Make changes to the System to ensure that the fee payment calculation includes each branch registered for more than 6 months before its fiscal yearend date."

OLAPC has updated IMF to adjust the calculation of recertification fees based on the approval date, fiscal year end, and branch approval date of the institutions. Before the update, the calculation counted back six months from the first day of the fiscal yearend month to determine if an institution owed the renewal fee or if a branch should be included in the recertification payment. The new calculation is based on the last day of the month and counts back six months. Going forward, any institution approved or branch added during the month of June for lenders with a fiscal year end of December 31st would be used to calculate the renewal payment.

"Make changes to the System to ensure that the system has a built-in cutoff date for lenders to delete branches."

OLAPC disagrees with this recommendation. OLAPC has a long standing policy that lenders are permitted to add or delete branches at any time. Recertification fees are not paid in arrears, but rather, are paid at the start of a fiscal year in order to continue participation in FHA programs for that fiscal year. OLAPC does not believe that, in deleting branches, lenders intend to circumvent controls or avoid payment, but that they are updating their records in FHA's systems. In order to reinstate a branch, a registration fee of $300 per branch is required, while only $200 per branch is required at renewal. It is not plausible that lenders would intentionally incur an additional $100 expense by acting in the manner suggested by the OIG.

Comment 7

Comment 8

In its exit conference with OLAPC, OIG stated that deleted branches had originated loans during the recertification period extending into the next fiscal year. OLAPC requested evidence corroborating this statement; however, the information received from the OIG was not sufficient for OLAPC to validate or refute OIG's assertion.

5

Ref to OIG Evaluation	Auditee Comments

"Make changes to the System to ensure that an estimated $178,600 in future fees collected from mortgagees can be available for the purposes of the FHA Single Family insurance program. The calculation for the $178,600 is provided in the Scope and Methodology section."

Comment 9

OLAPC notes that there are several variables which affect the validity of the amount stated above, including the projected participation of those 269 branches and 28 institutions omitted in the IMF fee calculations and the unmentioned 554 branches terminated during the audit period. OLAPC further understands that this amount will not be evaluated by OIG in any future audits of the Lender Recertification Branch.

Recommendation No. 2B

Collect $210,000 in underpaid fees from the 458 lenders that added offices in the seventh month before their fiscal year end that were not used in the fee calculation and $194,500 from the 217 lenders that were able to delete 973 branches in the System that were active beyond their previous fiscal year end date.

FHA Response

Comment 10

OLAPC maintains that these fees are not owed. As stated in the response to Recommendation 2A, the IMF renewal fee calculation has been changed to include branches added seven months prior to recertification. Additionally, there is no requirement to notify FHA of a branch closing or withdrawing. Lenders may delete branches at any time and in doing so are not attempting to avoid a higher required fee, but are simply updating their institution's profile. The renewal fee is a payment which permits a lender to continue participating in FHA programs in the upcoming year and should be based on a lender's current business structure.

Comment 11

OLAPC's review of OIG's findings revealed that 442, or 66% of the 675 lenders listed in the report, are no longer active as a result of recent policy changes, voluntary withdrawals or administrative actions. Collecting fees from inactive lenders would be very costly and difficult. Therefore, OLAPC believes that the cost of collecting these fees would likely outweigh any benefit and would most likely prove to be a misuse of resources that could be better allocated to other efforts that will more effectively reduce risks and losses to FHA's insurance funds.

6

OIG Evaluation of Auditee Comments

Comment 1: In several areas of its comments, FHA states that it has made changes to improve its lender renewal process. None of the changes were in place when we did our audit work so we have not evaluated their implementation or effectiveness. However, if the changes are implemented consistently, they should help improve the controls over the recertification process.

Comment 2: During the audit, the Division provided draft written standard operating procedures. However these procedures only specified referring lenders to the Mortgagee Review Board for submitting recertification items late. There was no other guidance in the procedures that specified Mortgagee Review Board referral for other violations such as insufficient lender net worth or liquidity.

Comment 3: Although the Division has begun implementing a more in-depth review of lenders, these controls were not fully in place during our audit scope and therefore have not been reviewed.

Comment 4: As noted in finding 1, we considered the changes required in the administrative process due to the 2007 ruling, and acknowledged the improvements made that strengthened controls over the lender renewal process.

Comment 5: Included in the deficiencies were reports that did not state that the audits were conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS). Without the report being prepared in accordance with GAGAS, including an adequate major compliance report and required disclosures, FHA cannot ensure that deficiencies would not pose an immediate threat to the public or the FHA insurance fund

Comment 6: The Division did not provide any internal policies and procedures that would explain the inconsistencies we found in the data. The status codes in the system need to accurately show any change in lender status so that the Division can ensure that the lender submits the correct recertification items. Since the Division relies on this system to monitor each lender's recertification, we continue to recommend that it makes changes to the system to ensure the data accurately reflect each lender's recertification status.

Comment 7: We agree that lenders are not likely to delete a branch then immediately reinstate the branch. Nonetheless, as noted in finding 2, 217 lenders were able to delete 973 branches. These branches were active in the system and could originate FHA loans beyond the recertification payment due date of 30 days past the lenders' fiscal year end dates. 317 of these branches remained active and were not deleted until at least 90 days past the lenders' fiscal year end dates.

Comment 8: We will provide the loan activity for the deleted branches referred to in the report under separate cover.

Comment 9: OLAPC is correct in its understanding that OIG will not be evaluating the $178,600 in future audits. This is just an estimate of the monetary benefit of implementing the recommendation.

Comment 10: HUD Handbook 4060.1 REV 2 chapter 4 states that a lender must remit an annual fee for its main office and any branch registered at least six months prior to the lender's fiscal yearend. Therefore, renewal fees are due for branches added seven months prior to the fiscal yearend.

Comment 11: We will consider a cost benefit analysis of collecting the unpaid fees from the 675 lenders from the Office of Lender Activities and Program Compliance.

Appendix C

LENDER ASSESSMENT SUBSYSTEM - LENDERS' FINANCIAL STATEMENT CERTIFICATION AND FINANCIAL INFORMATION TAB

Financial Statement Certification

CERTIFICATION STATEMENT

This is to certify that to the best of my knowledge and belief, the information contained in this submission - including but not limited to the accompanying FDT, DCF, and Notes & Findings - is accurate and complete for the period described on data element lines G9000-010, G2000-020, and G2000-030. By selecting Submit, I declare that the foregoing is true and correct.

Data Collections Form, Financial Statements Information Tab

General Information | Financial Statements

Element #	Description	Value	Details
G3000-005 *	Financial Statements prepared using GAAP basis	--Select--	--
G3000-006 *	Financial Statement Audit was conducted in accordance with:	--Select--	--
G3000-011 *	Type of Audit Opinion Issued	--Select--	Details
G3000-012 *	Type of SAS 29 Opinion on FDT	--Select--	--
G3000-020 *	"Going Concern" indicator - explanatory paragraph	--Select--	Details
G3000-030 *	Explanatory paragraph other than going concern	--Select--	Details
G3000-040 *	Reportable Condition and/or Material Weakness Indicator	--Select--	Details
G3000-070 *	Material Non-Compliance Indicator	--Select--	Details
G3000-090 *	Independent Auditor's Report on Financial Statements and Supplemental Information	--Select--	Details
G3000-100 *	Independent Auditor's Report on Internal Controls	--Select--	Details
G3000-110 *	Independent Auditor's Report on Compliance	--Select--	Details

Save Reset

Appendix D

LENDER ASSESSMENT SUBSYSTEM - INDEPENDENT PUBLIC ACCOUNTANT ATTESTATION

Attestation Agreed-Upon Procedures

The independent public accountant attests to the lender's submission once it is submitted for review. The agreed-upon procedures ensure the financial data entered into the Lender Assessment Subsystem by the lender are accurate and tie to the lender's hardcopy financial statements. By clicking the "Agrees" option button, the independent public accountant attests to the statements listed in the second paragraph of the independent public accountant's report.

> We conducted our audit of compliance with those requirements in accordance with auditing standards generally accepted in the United States of America, Government Auditing Standards, issued by the Comptroller General of the United States, and the Consolidated Audit Guide for Audits for HUD Programs (the "Guide"), issued by the U.S. Department of Housing and Urban Development, Office of Inspector General. Those standards and the Guide require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the Company's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

INDEPENDENT ACCOUNTANT'S REPORT ON APPLYING AGREED-UPON PROCEDURE

We have performed the procedure described in the second paragraph of this report, which was agreed to by ________ (the "lender") and the U.S. Department of Housing and Urban Development, solely to assist them in determining whether the electronic submission of certain information agrees with the related hard copy documents. The lender is responsible for the accuracy and completeness of the electronic submission. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedure is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedure described below either for the purpose for which this report has been requested or for any other purpose.

We compared the electronic submission of the items listed in the "UFRS Rule Information" column with the corresponding printed documents listed in the "Hard Copy Documents" column. The results of the performance of our agreed-upon procedure indicate agreement or non-agreement of electronically submitted information and hard copy documents as shown in the chart below.

We were engaged to perform an audit of the financial statements of the lender as of and for the year ended ________, and have issued our reports thereon dated ________. The information in the "Hard Copy Documents" column was included within the scope, or was a by-product, of that audit. Further, our opinion on the fair presentation of the Financial Data Templates (FDT) dated ________, was expressed in relation to the basic financial statements of the lender taken as a whole.

A copy of the financial statement package and the FDT, which includes the auditor's reports, is available in its entirety from the lender. We have not performed any additional auditing procedures since the date of the aforementioned audit reports. Further, we take no responsibility for the security of the information transmitted electronically to the U.S. Department of Housing and Urban Development.

This report is intended solely for the information and use of the lender and the U.S. Department of Housing and Urban Development, and is not intended to be and should not be used by anyone other than these specified parties.

Independent Public Accountant's Verification of Financial Information and Attachments

Procedure	UFRS Rule Information	HARD COPY DOCUMENTS	AGREES	DOES NOT AGREE
1	Balance Sheet, Statement of Operations and Changes in Retained Earnings and Statement of Cash Flows, and Computation of Adjusted Net Worth Schedule (data elements 111-1390 under the above listed tabs - "Details" links are included)	Financial Data Template	○	◉
2	Information about opinion on the financial statements, internal control and supplementary report on FDT (data elements G3000-005 - G3000-040 under the financial statements tab - "Details" links are <u>not</u> included)	Report on Basic Financial Statements, Report on Internal Control, Auditor's supplemental report on FDT	○	◉
3	Information about opinion on compliance and Type of Material Noncompliance (data elements G3000-070 - G3000-083)	Report on Compliance and Schedule of Findings and Questioned Costs	○	◉
4	Footnotes (data element G5000-010)	Footnotes to audited basic financial statements	○	◉
5	Audit Findings (data element G5200-010)	Schedule of Findings and Questioned Costs	○	◉
6	Corrective Action Plan (data element G5300-020)	Corrective Action Plan	○	◉