OFFICE OF AUDIT
REGION 7
KANSAS CITY, KS

U.S. Department of Housing and Urban Development

Preforeclosure Sale Program

2012-KC-0004 SEPTEMBER 18, 2012

U.S. DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT
OFFICE OF INSPECTOR GENERAL

Issue Date: September 18, 2012

Audit Report Number: 2012-KC-0004

TO: Charles Coulter, Deputy Assistant Secretary for Single Family Housing, HU

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

SUBJECT: FHA Paid Claims for Approximately 11,693 Preforeclosure Sales that Did Not Meet FHA Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final results of our review of the Preforeclosure Sale Program.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 913-551-5870.

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September 18, 2012

FHA Paid Claims for Approximately 11,693 Preforeclosure Sales that Did Not Meet FHA Requirements

Highlights

Audit Report 2012-KC-0004

What We Audited and Why

We reviewed the Federal Housing Administration (FHA) Preforeclosure Sale Program. We initiated this nationwide audit because we noted significant deficiencies in borrower qualifications during our audit of CitiMortgage's preforeclosure sale claims (2011-KC-1005, September 30, 2011).

Our audit objective was to determine whether the U.S. Department of Housing and Urban Development (HUD) paid claims for only preforeclosure sales that met the criteria for participation in the program.

What We Recommend

We recommend that HUD strengthen controls over the Preforeclosure Sale Program to put more than $781 million to better use. Funds to be put to better use is an estimate of funds that could be used more appropriately. It does not represent a direct reduction in costs to the insurance fund. It means that improved controls will prevent $781 million in insurance funds from being spent on future claims that do not qualify for the program. Additionally, we recommend that HUD require lenders to reimburse the FHA insurance fund for improper claims totaling $360,760.

What We Found

We found that 61 of 80 statistically selected claims from September 1, 2010, through August 31, 2011 did not meet the criteria for participation in the Preforeclosure Sale Program. Of these ineligible claims, 55 were submitted by the five lenders involved in the national mortgage settlement. In exchange for roughly $25 billion, the settlement pardoned these lenders' misconduct in loan servicing, including their processing of preforeclosure sale claims. The remaining six improper claims totaling $360,760 were submitted by lenders that were not involved in the national mortgage settlement.

By projecting our sample results, we estimate that HUD paid $1.06 billion in claims for 11,693 preforeclosure sales during our audit period that did not meet the criteria for participation in the program. While this amount of claims did not comply with HUD requirements, it does not represent a direct loss amount to the FHA insurance fund. The ultimate final cost to the FHA insurance fund would likely be less than this amount because it is reasonable to assume that at least some of these loans could have been processed differently and would have instead gone to foreclosure and become conveyance claims. However, it is also reasonable to assume that at least some of these loans would have resulted in no claim or reduced claims due to alternative loss mitigation procedures.

For purposes of estimating future benefits of improving the program, we made our estimate more conservative by removing 16 claims from the list of exceptions that we determined would have insufficient income to support the IRS collection standard's accepted expense levels. The projected dollar value of the remaining 45 claims is $781 million.

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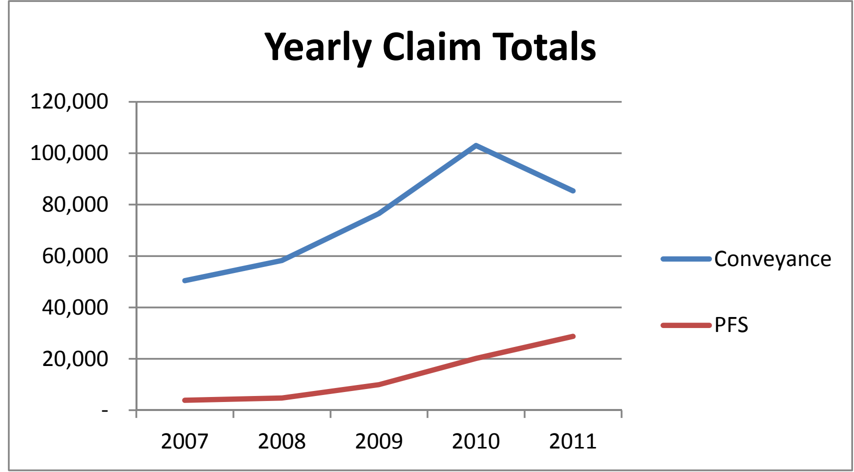
BACKGROUND AND OBJECTIVES

The Federal Housing Administration (FHA) provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. It is the largest insurer of mortgages in the world, having insured more than 34 million properties since its inception in 1934. FHA mortgage insurance provides lenders with protection against losses as the result of homeowners defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default.

FHA's Preforeclosure Sale Program allows borrowers in default (resulting from an adverse and unavoidable financial situation) to sell their home at fair market value and use the sale proceeds to satisfy the mortgage debt even if the proceeds are less than the amount owed. This program is appropriate for borrowers whose financial situation requires that they sell their home but they are unable to do so without FHA relief because the gross recovery on the sale of their property (that is, sales price minus sales expenses) is less than the amount owed on the mortgage. Lenders must maintain supporting documentation to demonstrate that they completed a comprehensive review of the borrower's financial records and that the borrower did not have sufficient income to sustain the mortgage. Lenders and borrowers who successfully complete a preforeclosure sale receive cash incentives of up to $1,000 for participating in the program. The program requirements are contained in 24 CFR (Code of Federal Regulations) 203.370 Pre-Foreclosure Sales and Mortgagee Letter 2008-43, Preforeclosure Sales (PFS) Program – Utilizing the PFS Loss Mitigation Option to Assist Families Facing Foreclosure, issued December 24, 2008 (see appendix D).

FHA paid claims on nearly 20,000 preforeclosure sales with claims totaling more than $1.7 billion from September 1, 2010, through August 31, 2011. The volume of preforeclosure sale claims has been increasing relative to foreclosure (conveyance) claims in the past 5 years.



* PFS = Preforeclosure Sale Program

Our audit objective was to determine whether HUD paid claims for only preforeclosure sales that met the criteria for participation in the program.

RESULTS OF AUDIT

Finding: HUD Paid More Than $1 Billion in Claims for Approximately 11,693 Preforeclosure Sales That Did Not Meet the Criteria for Participation in the Program

HUD paid claims for approximately 11,693 preforeclosure sales during our audit period that did not meet the criteria for participation in the program. HUD did not have adequate controls to enforce the program requirements, and the requirements were not well written. As a result, the FHA insurance fund may have taken unnecessary losses while borrowers, who may otherwise have been able to sustain their obligations, were inappropriately relieved of their debt using FHA insurance fund reserves.

Improper Claims Paid

FHA paid claims on nearly 20,000 preforeclosure sales with claims totaling more than $1.7 billion from September 1, 2010, through August 31, 2011. To conduct this audit, we focused on the 16,976 preforeclosure sale claims submitted by the 9 largest lenders according to preforeclosure sale volume. We selected a statistical sample of 80 claims from this universe of 16,976 (see Scope and Methodology for details of our selection).

Of the 80 files reviewed, 61, or 76.3 percent, were ineligible because they did not meet the criteria for participation in the program. The following table identifies how often each of the various deficiencies occurred in the 61 cases. The total number of claims depicted below exceeds the total number of cases reviewed because some cases had multiple deficiencies (see appendix C).

Deficiency	Number of claims
Borrower had assets	4
No adverse or unavoidable event	6
Not owner occupied	12
No income verification	15
Borrower had surplus income – verified income exceeds claimed expenses verified income exceeds verified expenses	 12 48

By projecting these ineligible claims to the universe of 16,976 claims, we estimated that at least 11,693 of the claims were ineligible. By projecting the average ineligible amount per claim, we estimated that the total value of the

ineligible claims was $1.06 billion (see Scope and Methodology for details of our projections).

Borrower Had Assets

HUD paid four claims for borrowers who had at least $5,000 in cash assets. Mortgagee Letter 2008-43 prohibits borrowers with assets from participating in the program. In some cases, borrowers had bank balances equivalent to 7 to 9 months' worth of mortgage payments but were not required to put those funds toward the delinquent mortgage balance, even when it could have brought the mortgage current.

No Adverse or Unavoidable Event

HUD paid six claims for borrowers who did not demonstrate that they had experienced an adverse and unavoidable financial hardship. According to section C of 24 CFR 203.370 and section B of the mortgagee letter, adverse and unavoidable financial situations may include but are not limited to loss of job or verifiable income reduction and extensive medical expenses. In some cases, the borrower's claimed hardship was related to a nonborrower spouse or significant other whose income and asset information was not considered when qualifying to participate in the program. In one case, the borrower claimed that his income had been decreasing, but documents in the case file showed that it had been increasing.

Not Owner Occupied

HUD paid 12 claims for borrowers who did not occupy the property. Section C of the CFR and section B of the mortgagee letter require participants in the program to be owner-occupants. Lenders are authorized to grant reasonable exceptions to nonoccupant borrowers when it can be demonstrated that the need to vacate was related to the cause of default and the subject property was not purchased as a rental or used as a rental for more than 18 months before the borrower's acceptance into the program. We noted instances in which the borrower's income tax return listed the property as a rental for several years. In other cases, the borrower reported the property as a rental in statements to the lenders.

No Income Verification

HUD paid 15 claims for which the lenders did not properly calculate or verify the borrowers' income. Section D of the mortgagee letter requires lenders to estimate the borrower's anticipated monthly net income, making necessary adjustments for income fluctuations, and independently verify the financial information provided by the borrower. In some cases, the lenders calculated income based on only one coborrower; in other cases, the lender determined borrower income without verifying it with either bank statements or earnings statements. Finally, in some cases, the lender did not obtain tax returns or profit-and-loss statements to verify the income of self-employed borrowers.

Borrower Had Surplus Income

HUD paid 48 claims for which the lender did not adequately verify expenses to show negative surplus income. Section D of the mortgagee letter requires lenders to estimate the borrower's fixed monthly expenses (such as mortgage payment, food, utilities, car payment, and outstanding obligations) and independently verify the financial information provided by the borrower. Lenders must then subtract expenses from income to determine the amount of surplus income available each month, and borrowers with positive surplus income are required to repay the indebtedness through the use of a repayment plan.

In nearly all of the cases reviewed, expenses claimed by the borrowers exceeded those verified by the lender. Lenders often obtained bank statements but did not show an attempt to reconcile them to expenses claimed by the borrower. Since lenders largely verified only expenses shown on the credit report, in many cases, borrowers were approved to participate in the program despite their verified income exceeding their verified expenses. In 12 cases, the borrowers' verified income even exceeded their claimed expenses.

Inadequate Controls

HUD did not have adequate controls to enforce the program requirements, and the requirements were not well written.

Oversight

HUD did not adequately monitor and enforce the program requirements. Before paying a claim, HUD had certain built-in edit checks to ensure that it paid accurate amounts. However, these edit checks did not address whether the borrower was qualified. Rather, they checked computations and relationships among various fields. Since lenders did not submit their files to HUD, HUD was not able to ensure the validity of the claim before paying it. HUD instead relied entirely on the lender to have followed the mortgagee letter in approving the borrower for the program.

After paying claims, HUD's claims department reviewed a sample of all claims paid including those related to preforeclosure sales. During our audit period, the scope of this review did not include borrower qualification for the program. Therefore, HUD did not inform lenders of their deficient activities in this program. During the summer of 2011, HUD added borrower qualification to the scope of the review and found problems similar to those reported in this finding. While this is a positive step, HUD needs to incorporate this as part of an overall strategy of monitoring and enforcing the program guidance that includes the use of administrative and civil sanctions against lenders that violate program requirements.

Design

The mortgagee letter clearly states the restrictions of the program and identifies the qualifications necessary for borrowers to participate in the program. However, it does not contain enough detail to ensure that lenders consistently apply the requirements and evaluate the qualifications. HUD designed the program requirements to give lenders more flexibility and increase participation in the program. HUD stated that the mortgagee letter was not written to address a situation in which so many homes had negative equity and that changing the program now, in light of current economic conditions, would be problematic and cause the program to be less useful when conditions improved. Specifically, HUD stated that it believed program requirements too strictly defined would create their own problems.

The resulting mortgagee letter is not as helpful to the lenders as it could be if it spelled out the requirements in more detail (see appendix E). For example, the requirement that lenders disapprove borrowers with assets lacks detail. We conservatively applied the mortgagee letter to cite only those with cash assets over $5,000 and to not cite any who lacked asset verification. One lender asserted that it thought assets mattered only if they were sufficient to pay off the mortgage. HUD could avoid such misunderstanding by providing more detail to instruct the lenders. In addition, the requirement that lenders independently verify a borrower's expenses was difficult to apply since not all monthly expenses can be easily verified with a monthly statement. If the mortgagee letter had based expenses on standardized allowances such as the Internal Revenue Service (IRS) Collection Financial Standards (see Scope and Methodology), it would have been easier, more objective, and more likely to be applied consistently.

Ineligible FHA Insurance Fund Claims

The FHA insurance fund paid improper claims of more than $1 billion while borrowers who may otherwise have been able to sustain their obligations were inappropriately relieved of their debt using FHA insurance fund reserves.

Using statistical sampling procedures to project the ineligible claims to the universe of 16,976 claims, we estimated that HUD paid at least $1 billion in improper claims. The $1 billion does not represent a direct loss to the FHA insurance fund. The ultimate final cost to the FHA insurance fund would likely be less than this amount because it is reasonable to assume that at least some of these loans could have been processed differently and would have instead gone to foreclosure and become conveyance claims. However, it is also reasonable to assume that at least some of these loans would have resulted in no claim or reduced claims due to alternative loss mitigation procedures.

During the most recent 5-year period, the loss per preforeclosure sale dramatically increased as the volume of preforeclosure sale claims submitted to HUD also

dramatically increased. HUD expects the volume of preforeclosure sale claims to continue to increase. As a result, HUD will continue to pay improper claims if it does not improve its controls over this program. For the purposes of estimating future benefits, we estimate more than $781 million will be put to better use over the next year if HUD implements our recommendations. To make this estimate more conservative, we removed 16 claims from our list of exceptions because we determined that the borrowers' expenses, using the IRS collection standards' accepted expense levels, would have been higher than their verified incomes. This estimate of future benefits is the amount we believe will not be paid in claims or will be paid for eligible claims instead of ineligible claims over the next year (see Scope and Methodology).

The mortgagee letter explicitly states that under no circumstances may the program be made available to borrowers who have abandoned their mortgage obligation despite their continued ability to pay. Any borrower allowed to participate in the program without demonstrating his or her need for assistance or despite having assets, surplus income, or other means of sustaining the mortgage has been inappropriately relieved of their debt. The results of our review show that HUD's controls over this program were not strong enough to prevent this inappropriate debt relief.

Conclusion

HUD paid more than $1 billion for preforeclosure sale claims that did not comply with FHA's preforeclosure sale program requirements. The lenders allowed borrowers to complete preforeclosure sales at FHA's expense without verifying the borrowers' compliance with requirements related to hardship, owner-occupancy, and a borrower's inability to afford the mortgage. Of the 61 improper claims identified during this audit, 55 were submitted by the five lenders involved in the national mortgage settlement. In exchange for roughly $25 billion in relief for distressed borrowers, States, and the Federal Government, the settlement pardoned these lenders' misconduct in loan servicing, including their processing of preforeclosure sale claims. The remaining six improper claims totaling $360,760 were submitted by lenders that were not involved in the national mortgage settlement. HUD should recover the $360,760 in losses from those lenders.

HUD also needs to strengthen controls to help ensure future program compliance and ensure that it pays only eligible preforeclosure sale claims.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

1A. Require lenders to reimburse the FHA insurance fund for six of the improper claims totaling $360,760.

1B. Strengthen controls over the preforeclosure sale program, including the mortgagee letter and program oversight, to put more than $781 million to better use.

1C. Educate lenders on the appropriate and proper use of the Preforeclosure Sale Program.

SCOPE AND METHODOLOGY

To accomplish our objective, we

- Interviewed HUD staff;
- Reviewed Federal regulations, HUD handbooks, and mortgagee letters; and
- Selected and reviewed a statistical sample of preforeclosure sale case files.

We performed our audit work between November 2011 and May 2012. We conducted audit fieldwork at HUD headquarters at 451 7th Street Southwest, Washington, DC. Our audit generally covered the period September 1, 2010, through August 31, 2011.

We relied in part on data maintained by HUD in its Neighborhood Watch Early Warning System and Single Family Data Warehouse database. Specifically, we relied on the systems to identify preforeclosure sales that closed during our audit period and the associated claim amounts. Although we did not perform a detailed assessment of the reliability of the data, we determined that the computer-processed data were sufficiently reliable for our purposes because the data in the sampled items were corroborated by documentary evidence supplied by the sampled lenders.

From September 1, 2010, through August 31, 2011, FHA paid 19,567 preforeclosure sale claims totaling more than $1.7 billion. The nine lenders with the highest volume of preforeclosure sales submitted more than 87 percent of these claims. We limited the sample universe to these top nine. In addition, we excluded as outliers 79 loan claims that exceeded $300,000 to control for accuracy. This universe amounts to 16,976 claims totaling more than $1.5 billion.

A 16-strata sample design was used to control for variance attributable to the size of the loan claim and for different lengths of time in default before going to claim. The sample design was tested with various rates of error to confirm that a reliable answer could be obtained and that the confidence intervals, as specified, would provide an accurate probabilistic statement. Replicated sampling was used to simulate 1,000 different audits for each of several sample sizes and types of error we might find in the field. As a safety measure, the design was stress tested under conditions that concentrated improper payments in the smaller strata associated with short times to default. In this manner, we verified that the randomly selected sample design wouldn't misread important information concentrated in a small area of the sample. (Actual error rates found proved to be more uniformly distributed and yielded a variance that was more easily controlled.) Based on the testing and simulated sampling distributions, a stratified sample of 80 loans was found to be sufficient. The stress testing proved the sample design to be sufficient to provide better than a one-sided confidence interval of 95 percent in situations designed for that threshold. The sample design was stratified as shown in the following table.

Strata Design							
Strata (lag/tier)	Tier (size of claim)	Loans	pct of loans	Total Claims	pct of claims	Sample Size	Selection Prob
1-3 mos. - tier1	$0 - $39,999	321	1.9%	$8,517,196	0.6%	2	0.0062
1-3 mos. - tier2	$40,000 - $69,999	392	2.3%	$21,419,175	1.4%	2	0.0051
1-3 mos. - tier3	$70,000 - $110,000	345	2.0%	$29,790,967	2.0%	2	0.0058
1-3 mos. - tier4	$110,000 -$300,000	144	0.8%	$19,953,512	1.3%	2	0.0139
4-6 mos. - tier1	$0 - $39,999	622	3.7%	$17,056,241	1.1%	3	0.0048
4-6 mos. - tier2	$40,000 - $69,999	854	5.0%	$47,117,347	3.1%	4	0.0047
4-6 mos. - tier3	$70,000 - $110,000	756	4.5%	$66,013,930	4.4%	3	0.0040
4-6 mos. - tier4	$110,000 -$300,000	429	2.5%	$59,036,041	3.9%	2	0.0047
7-12 mos. - tier1	$0 - $39,999	978	5.8%	$26,491,346	1.8%	4	0.0041
7-12 mos. - tier2	$40,000 - $69,999	1,883	11.1%	$104,125,071	6.9%	9	0.0048
7-12 mos. - tier3	$70,000 - $110,000	2,044	12.0%	$180,834,191	12.0%	9	0.0044
7-12 mos. - tier4	$110,000 -$300,000	1,544	9.1%	$225,116,036	14.9%	7	0.0045
>12 mos. - tier1	$0 - $39,999	541	3.2%	$15,167,767	1.0%	2	0.0037
>12 mos. - tier2	$40,000 - $69,999	1,414	8.3%	$78,982,269	5.2%	7	0.0050
>12 mos. - tier3	$70,000 - $110,000	1,920	11.3%	$171,729,625	11.4%	9	0.0047
>12 mos. - tier4	$110,000 -$300,000	2,789	16.4%	$436,687,685	29.0%	13	0.0047
		16,976	100.0%	$1,508,038,399	100.0%	80	

We reviewed the statistical sample of preforeclosure sale case files to evaluate whether the lender verified that the borrower

- Suffered an adverse and unavoidable financial hardship,
- Did not have surplus assets,
- Did not have surplus income,
- Accurately stated income,
- Accurately stated expenses,
- Was in danger of imminent default if applicable,
- Was the owner-occupant of the subject property,
- Did not have another FHA-insured mortgage, and
- Was more than 30 days delinquent when the short sale closed.

And that (1) the mortgage payoff amount exceeded the "as-is" fair market value of the home, (2) the home was listed for sale at or near the appraised "as-is" fair market value, and (3) the sale generated the minimum net sales proceeds required by the program.

For the purposes of our review, borrowers were considered to have surplus assets when they had more than $5,000 in cash and surplus income when income less expenses resulted in a positive residual greater than zero.

We determined that 61 of the 80 sampled loans, or 76.3 percent, did not meet the criteria for participation in the program. Adjusting for sampling weights, that became an estimated mean of 76.5 percent of loans with improper payments. Given the laws of probability, all randomly selected samples are subject to a margin of error or "statistical variance," which must be accounted for. Deducting for statistical variance, we can still say—with a one-sided confidence interval of 95 percent—that at least 11,693 of the 16,976 loans in the population had a similar problem.

Blending together failing and conforming loans we get an average amount of improper payment that can be applied to the entire 16,976 loans. This amounts to $70,381 per loan. The average was computed based on the sampling weights and loan counts within the stratified sample. Deducting for statistical variance to accommodate the uncertainties inherent to statistical sampling, we can still say—with a one-sided confidence interval of 95 percent—that improper payments amounted to $62,434 per loan (rounded). Extending this amount to the general population of 16,976 loans, we can say—with a one-sided confidence interval of 95 percent—that total improper payments amounted to at least $1.06 billion.

To arrive at a more conservative estimate of funds to be put to better use, we reclassified 16 of our failed sample claims as allowable and re-projected our results to the universe. For those 16 claims, we determined that the individual borrowers would likely have been eligible for participation in the program if the lender had adequately conducted all required verifications. We made that determination by applying the IRS Collection Financial Standards to each borrower in our sample combined with loan payments confirmed by their credit report, and found that for these 16 claims, the borrower's standardized monthly expenses exceeded their verified monthly income. This leaves 45 loan claims within the stratified sample that were improperly paid with an average improper payment of $55,591 per loan. Deducting for statistical variance—we can say with a one-sided confidence interval of 95 percent—that improper payments amounted to $46,044 per loan (rounded). Extending this to the general population of 16,976 loans we can say with a one-sided confidence of 95 percent that the total amount of improper payments would amount to at least $781 million over the next year if HUD does not implement our recommendations.

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 financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Controls over program design and oversight.

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 Preforeclosure Sale Program was not adequately designed or overseen (see finding).

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/
1A	$360,760	
1B		$781,642,944

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.

In this instance, if HUD implements our recommendations, it will ensure that preforeclosure sale claims are paid only for qualifying borrowers to lenders that have followed all of the program requirements. It will no longer pay claims for borrowers who have not demonstrated an adverse and unavoidable financial situation, owner-occupancy, or an inability to sustain the mortgage. Our estimate reflects only the initial year of this benefit. These amounts do not include potential offsetting costs incurred by HUD to implement our recommendations to strengthen controls.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

OFFICE OF HOUSING

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

September 17, 2012

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

FROM: Charles S. Coulter, Deputy Assistant Secretary Single Family Housing, HU

SUBJECT: Auditee Response
FHA Preforeclosure Sale Program
Audit No: 2012-KC-000X

The Office of Inspector General (OIG) reviewed the Federal Housing Administration's (FHA) Preforeclosure Sale Program. OIG performed this nationwide audit because of noted significant deficiencies in borrower qualifications during their audit of CitiMortgage's compliance with FHA's Preforeclosure Sale (PFS) claims (2011-KC-1005, September 30, 2011). OIG's audit objective was to determine whether the U.S. Department of Housing and Urban Development (HUD) paid claims for only those preforeclosure transactions that met the criteria for participation in the program.

Comment 1

The Office of Single Family Housing acknowledges that existing PFS policy and lender execution against that policy is inconsistent. To improve alignment and ensure that the long-term interest of the FHA Insurance Fund are met, FHA is working toward: (1) introducing a streamline PFS approval policy based on loan characteristics and borrower credit profile; and (2) specifying income documentation requirements for the deficit income test that must be met for borrowers that do not meet the streamline requirements.

Comment 2

The Office of Single Family Housing would also note that the 80 loans sampled by the OIG had an average credit score of 596 and an average delinquency of 8.7 months. Given this profile, it is likely that most of the 80 loans would have been conveyed to FHA as real estate owned (REO) if the PFS transactions had not been approved. Since the recovery rate of all PFS transactions is 53 percent and the recovery rate for single family REO sales is 36 percent, the claims paid by FHA on the PFS transactions were lower than they otherwise would have been and may have resulted in a net benefit to the FHA Insurance Fund of as much as $170 million.

Regardless of the economic impact to the FHA Insurance Fund, the Office of Single Family Housing recognizes the need for strong, clear PFS policies and lender oversight. The Office of Single Family Housing will work closely with the OIG to ensure that these objectives are met and that the issues identified in the report are rectified.

www.hud.gov espanol.hud.gov

OIG Evaluation of Auditee Comments

Comment 1 We agree that FHA needs strong, clear preforeclosure sale policies and oversight. These policies should align with FHA expectations and be designed to adequately protect the insurance fund. To address the issues identified in the report, these policies should include 1) a standardized intake form requiring the borrower to certify complete information on income and assets, 2) an objective method to evaluate whether a borrower should be required to forfeit some assets to participate, and 3) an objective method to document and evaluate the borrower's hardship and financial need.

Comment 2 FHA asserts that it is likely that most of the 80 sampled properties would have been foreclosed upon if the preforeclosure sale transactions had not been approved. We did not evaluate that type of data as part of the scope of this audit. Reaching this conclusion would entail significant analysis of possible assumptions and existing data. It is also important to note that the difference in loss rates between preforeclosures and foreclosures has been narrowing. The average preforeclosure sale loss rate has been increasing more steeply than the average conveyance claim loss rate. We do not know how much more this difference will narrow and cannot make any conclusion about whether it will be cost beneficial to loosen the rules to allow more preforeclosure sale claims, but allow more marginal borrowers to participate.

Appendix C

SCHEDULE OF LOAN DEFICIENCIES

Sample item number	Assets	Lacks adverse event	Not owner-occupant	Income not verified	Verified income exceeds claimed expenses	Verified income exceeds verified expenses	# of loans not eligible	Would qualify under OIG's alternative objective expenses test
1						x	x	x
2								
3						x	x	x
4		x		x			x	
5		x				x	x	
6			x			x	x	
7	x				x	x	x	
8					x	x	x	
9								
10		x				x	x	
11								
12				x		x	x	
13				x			x	
14								
15								
16						x	x	
17						x	x	x
18		x			x	x	x	
19						x	x	
20				x			x	
21					x	x	x	x
22			x				x	
23				x		x	x	
24		x				x	x	
25								
26								
27								
28								
29				x			x	
30						x	x	x
31								
32			x			x	x	
33			x	x		x	x	
34								
35	x				x	x	x	
36					x	x	x	

Sample item number	Assets	Lacks adverse event	Not owner-occupant	Income not verified	Verified income exceeds claimed expenses	Verified income exceeds verified expenses	# of loans not eligible	Would qualify under OIG's alternative objective expenses test
37					x	x	x	
38	x		x		x	x	x	
39				x		x	x	
40			x			x	x	
41								
42				x			x	
43								
44								
45	x			x	x	x	x	
46				x			x	
47						x	x	
48			x			x	x	
49			x			x	x	
50				x	x		x	
51						x	x	x
52						x	x	x
53						x	x	x
54						x	x	x
55								
56								
57						x	x	
58						x	x	x
59					x	x	x	x
60						x	x	
61				x			x	
62						x	x	x
63						x	x	x
64								
65						x	x	
66			x			x	x	
67								
68								
69			x				x	
70						x	x	
71						x	x	x
72			x				x	
73						x	x	x
74				x			x	
75			x			x	x	
76						x	x	

Sample item number	Assets	Lacks adverse event	Not owner-occupant	Income not verified	Verified income exceeds claimed expenses	Verified income exceeds verified expenses	# of loans not eligible	Would qualify under OIG's alternative objective expenses test
77		x			x	x	x	
78				x			x	
79						x	x	x
80						x	x	
	4	6	12	15	12	48	61	16

Appendix D

CRITERIA

24 CFR 203.370 - Pre-foreclosure sales.

(a) General. HUD will pay FHA insurance benefits to mortgagees in cases where, in accordance with all regulations and procedures applicable to pre-foreclosure sales, the mortgaged property is sold by the mortgagor, after default and prior to foreclosure, at its current fair market value (less adjustments as the FHA Commissioner may deem appropriate) but for less than the mortgage loan amount currently outstanding.

(b) Notification of mortgagor. The mortgagee shall give notice, according to prescribed procedures, of the opportunity to be considered for the pre-foreclosure sale procedure to each mortgagor in default. All notices to mortgagors must be in an accessible format, if requested, or if required by the person's known disability, as required by 24 CFR part 9.

(c) Eligibility for the Pre-foreclosure Sale Procedure. In order to be considered for the pre-foreclosure sale procedure, a mortgagor:

(1) Must be an owner occupant in a single family residence that is security for a mortgage insured under this part, unless otherwise prescribed by the [HUD] Secretary.
(2) Must have an account in default, for such period as determined by the Secretary, which default is the result of an adverse and unavoidable financial situation.
(3) Must have, at the time application is made to pursue a pre-foreclosure sale, a mortgaged property whose current fair market value, compared to the amount needed to discharge the mortgage, meets the criterion established by the Secretary, unless a variance is granted by the Secretary.
(4) Must have received an appropriate disclosure, as prescribed by the Secretary.

Excerpts From Mortgagee Letter 2008-43: Pre-Foreclosure Sale (PFS) Program - Utilizing the PFS Loss Mitigation Option to Assist Families Facing Foreclosure

Pre-Foreclosure Sale Introduction

The Pre-Foreclosure Sale (PFS) option allows mortgagors in default (resulting from an adverse and unavoidable financial situation) to sell their home at FMV [fair market value] and use the sale proceeds to satisfy the mortgage debt even if the proceeds are less than the amount owed. This option is appropriate for mortgagors whose financial situation requires that they sell their home, but they are unable to do so without FHA relief because the gross recovery on the sale of their property (i.e., sales price minus sales expenses) is less than the amount owed on the mortgage. HUD's home retention alternatives such as Special Forbearance, Mortgage Modification, or Partial Claim must first be considered and determined unlikely to succeed due to the mortgagor's financial situation. Mortgagees must maintain supporting documentation to demonstrate that a comprehensive review of the mortgagor's financial records was completed,

and that the mortgagor did not have sufficient income to sustain the mortgage. Under no circumstances shall the PFS option be made available to mortgagors who have abandoned their mortgage obligation despite their continued ability to pay.

To participate in the program, mortgagors must be willing to make a commitment to actively market their property for a period of 3 months, during which time the mortgagee delays foreclosure action. Mortgagors who successfully sell to a third party within the required time may receive a cash consideration of up to $1,000. Mortgagees also receive a $1,000 incentive for successfully avoiding the foreclosure and complying with all the requirements of this ML [mortgagee letter]. If the property does not sell, mortgagors are encouraged to use the deed-in-lieu of foreclosure (DIL) option, providing the title on the property is marketable. By following procedures and time frames included in this ML, a mortgagee may submit a FHA insurance claim and be compensated for the difference between the sale proceeds and the amount owed on the mortgage (including accrued interest and reimbursable costs).

A PFS sale must be an outright sale of the property. If a foreclosure occurs after the mortgagor unsuccessfully participated in the PFS process in good faith, neither the mortgagee nor HUD will pursue the mortgagor for a deficiency judgment.

B. Mortgagor Qualifications

The PFS option may be extended to mortgagors who:

- Are in default as a result of an adverse and unavoidable financial situation. Adverse and unavoidable financial situations may include but are not limited to loss of job or verifiable income reduction and extensive medical expenses;

- Have negative equity as determined by an "as-is" FHA appraisal that indicates a property value less than 100% of the outstanding mortgage balance (including unpaid principal and accrued note rate interest) and any outstanding Partial Claim amounts, which are secured by a subordinate lien and/or a note. A PFS may be considered if the property's "as-is" appraised FMV slightly exceeds the mortgage payoff figure, but gross sales proceeds fall short of the amount needed to discharge the mortgage by more than $1,000;

- Are owner-occupants of a one-to-four unit single-family dwelling with a FHA-insured mortgage under Title II of the National Housing Act. Mortgagees are authorized to grant reasonable exceptions to non-occupant borrowers when it can be demonstrated that the need to vacate was related to the cause of default (e.g., job loss, transfer, divorce, death), and the subject property was not purchased as a rental or used as a rental for more than 18 months prior to the mortgagor's acceptance into the PFS Program;

- Have only one FHA-insured loan. Mortgagees are authorized to make reasonable exceptions for mortgagors who have acquired an FHA-insured property through inheritance or co-signed a FHA-insured loan to further enhance the credit of another mortgagor; or

- Are not a corporation or partnership (i.e., unless a written request to utilize the PFS has been approved by HUD's National Servicing Center (NSC)).

D. Financial Analysis

Prior to signing Form HUD-90045 (*Approval to Participate*), the mortgagee must request financial documentation to evaluate the mortgagor's ability to support the mortgage debt. The PFS option may not be offered to mortgagors who have sufficient personal resources to pay off their mortgage commitment.

The mortgagee may prescribe the form that the mortgagor must use to submit its financial information. Mortgagors may provide financial information during a telephone interview, electronically, via the regular mail, or in person. Regardless of how the mortgagor's financial information is obtained, the mortgagee must independently verify the financial information. Mortgagors with surplus income and/or other assets are required to re-pay the indebtedness through the use of a repayment plan.

The mortgagee must analyze the mortgagor's ability to meet the monthly mortgage obligation by:

- Estimating the borrower's fixed monthly expenses (e.g., mortgage payment, food, utilities, car payment, outstanding obligations, etc.);

- Estimating the borrower's anticipated monthly net income (making necessary adjustments for income fluctuations); and

- Subtracting expenses from income to determine the amount of surplus income available each month.

If the mortgagee's evaluation indicates that the mortgagor is not eligible for a PFS or another loss mitigation option, the mortgagee must immediately advise the mortgagor of this decision in writing, explaining the reason for denial and giving the mortgagor at least seven calendar days to respond. In the servicing or claim review file, the mortgagee must maintain all evidence (i.e., supporting documentation, including all communication logs) of compliance with HUD's Loss Mitigation Program requirements.

Appendix E

MORTGAGEE LETTER 2008-43 WEAKNESSES

Assets
The mortgagee letter does not define the amount or types of assets that a lender should consider. It does not set a threshold at which assets become relevant; that is, there is no static dollar amount or number of payments represented by the asset value that the mortgagee letter defines as significant. Additionally, the mortgagee letter doesn't dictate whether borrowers' retirement accounts, such as 401(k)s and individual retirement accounts, must be liquidated before the borrowers may participate in the program. Retirement accounts are usually protected from seizure during bankruptcy; however, they go into a larger total, including other personal and business assets, that is used by the IRS to determine a taxpayer's "true ability to pay" a tax debt. The mortgagee letter also does not state whether borrowers are required to liquidate other assets, such as investment real estate, recreational vehicles, or other personal valuables.

HUD has not mandated the use of a universal application or intake form for the program; therefore, some lenders' requests for financial information from the borrower include only voluntary assets available, and some do not ask about assets at all. Since lenders did not always obtain bank statements, we do not know how many additional borrowers had disqualifying cash assets. In one example, the file included a bank statement for a borrower, showing very little cash on hand, but failed to include a bank statement for one of the borrower's other accounts with more than $5,000 on deposit during the month in which she wrote her hardship letter.

Hardship
The mortgagee letter does not specify whether a lender should consider borrowers' claimed hardships that may have been avoidable or a result of personal choice but resulted in the borrower's being unable to sustain the mortgage. As written, it allows only for situations that are both adverse and unavoidable.

Income Verification
The mortgagee letter does not prescribe how lenders should verify borrowers' monthly net income when determining the borrowers' ability to sustain the mortgage. Unlike loan origination standards, which prescribe how a lender is to verify a potential borrower's income, the Preforeclosure Sale Program does not detail the level and method of verification required.

Expense Verification and Mortgage Priority
The mortgagee letter does not describe how to verify borrowers' monthly expenses or address borrower circumstances. HUD has not described how a borrower's situation should be evaluated when the borrower's credit report reflects large past-due balances as monthly payment amounts due or accounts included in bankruptcy.

HUD officials told us that a "standard of reasonableness should be applied" when verifying expenses, but such a standard has not been established by HUD according to household size,

geographic location, or any other factor. We attempted to reevaluate the claims using a reasonable standard for other expenses, such as food, clothing, apparel and services, personal care products and services, and transportation, by using the IRS Collection Financial Standards (for use in calculating repayment of delinquent taxes). Because the Standards do not include a standard for utilities, we also used the U.S. Department of Labor's Relative Importance in the Consumer Price Index to determine an objective amount for utilities.

Of the 28 sample items, which were only deficient in that expenses had not been verified by the lender, 16 passed using our alternative objective expenses method. That is, in 16 cases, the expenses supported by the borrowers' credit report, IRS Collections Financial Standards, and Relative Importance in the Consumer Price Index would have exceeded the borrowers' verified income (these cases are still listed as exceptions in this report because the lenders did not follow the program requirements).

HUD doesn't require the mortgage to take priority over any of the borrowers' discretionary spending or require borrowers to reduce other expenses. The mortgagee letter also doesn't specify whether "fixed" expenses include all discretionary spending. As a result, all of the borrower's claimed expenses are totaled, and if a monthly shortfall results, the lender assumes that the borrower qualifies for the program without considering whether the borrower could reduce other expenses to afford the mortgage.

In some cases, borrowers made significant charitable contributions or gambling expenditures instead of making their mortgage payment. In other cases, the borrowers failed to make mortgage payments to provide financial support to family members not on the mortgage or to make other large purchases, and in one case, a borrower made the maximum yearly tax-deductible 401(k) contribution of more than $16,000 during the year the borrower qualified for the program. If HUD would adopt an objective expense allowance rather than the current method, it would alleviate some of these concerns.

Surplus Income

The mortgagee letter does not explicitly state by how much income must exceed expenses to be considered surplus or whether any surplus is considered sufficient to sustain the mortgage. As it is written, a borrower with any surplus income is disqualified from the program.