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BY THE COMPTROLLER GENERAL

Report To Charles H. Percy, United States Senate

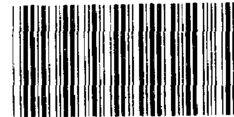
OF THE UNITED STATES

Defaulted Title I Home Improvement Loans -- Highly Vulnerable To Fraud, Waste, And Abuse

Millions of dollars in defaulted home improvement loans that could be collected are written off annually by the Department of Housing and Urban Development (HUD). By eliminating wasteful management practices, strengthening controls to prevent fraud and abuse, and using locator services to find debtors, this annual loss could be decreased.

GAO found that about 14 percent of the defaulting home improvement borrowers had more than one loan in default. Some borrowers, by not reporting earlier loans, were able to obtain loans after defaulting on those previously received.

HUD promises to emphasize collection of these debts, including better controls to prevent program abuses. HUD must also remove incentives that encourage current borrowers to default, such as the practice of reducing loan interest charges by as much as 13 percent after default.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-202071

The Honorable Charles H. Percy
United States Senate

Dear Senator Percy:

As you requested, we have reviewed the Department of Housing and Urban Development's (HUD's) loan servicing and accounting for defaulted Title I loans. Under the Title I program HUD guarantees loans made by private lenders for home improvement. Defaulted loans are acquired by HUD when borrowers fail to make their loan payments and the lenders return the loans to HUD for payment of an insurance claim.

At the beginning of fiscal 1981, HUD had defaulted loans valued at over $130 million. Based on recent collection experience HUD estimated over $106 million of this would be uncollectible. Millions may have been lost unnecessarily in past years because inadequate management attention was placed on collecting these debts. Our report discusses system weaknesses allowing the deficiencies to occur and recommends specific ways to correct the weaknesses.

As arranged with your office, unless you publicly announce its contents earlier we plan no further distribution of this report until 30 days from its date. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE HONORABLE CHARLES H. PERCY UNITED STATES SENATE

DEFAULTED TITLE I HOME IMPROVEMENT LOANS--HIGHLY VULNERABLE TO FRAUD, WASTE, AND ABUSE

DIGEST

As a result of a lack of management attention, an inadequate accounting system, and failure to aggressively service every loan, millions of dollars owed the United States for defaulted home improvement loans have not been collected. The Department of Housing and Urban Development (HUD) should place more emphasis on collection of these loans, including wider use of such collection tools as locator services and legal remedies.

At the request of Senator Charles H. Percy, GAO reviewed HUD's accounting and loan servicing for defaulted Title I home improvement loans. Under the Title I program, borrowers obtain home improvement loans from participating lenders. In return for an insurance premium, credit insurance is provided which assures the lender that if the borrower defaults HUD will pay off 90 percent of the loan balance. Since 1969, the program has also been used to insure loans financing the purchase of mobile homes.

GAO found that, as a result of inadequate controls and outdated management practices, millions of dollars owed the United States have been subjected to waste, fraud, and abuse. Nationwide, thousands of borrowers have more than one home improvement loan in default. (See p. 8.) Since credit reports did not always show the previous loans, borrowers were often able to obtain multiple loans by simply not including information about other loans on their loan applications. Legislation such as the Debt Collection Act of 1981 (S. 1249) has been introduced in the Congress to, among other things, help reduce future program abuses resulting from incomplete loan applications. If enacted, this legislation would provide Federal agencies, including HUD, specific authorization to report defaulting borrowers to credit bureaus. (See p. 14.)

In fiscal 1980 HUD wrote off over $18 million in defaulted home improvement loans and estimated

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that over $106 million of the $130 million in defaulted loans on hand at the end of fiscal 1980 would not be collected. The following wasteful management practices and accounting problems contribute to this high volume of uncollectible home improvement loans.

--HUD's loan servicing is not in compliance with Federal Claims Collection Standards. In New York and Chicago it took HUD an average of 8 months after defaulted loans were returned to send the first collection letter to the borrower. The letters were not mailed, in some cases, for over 3 years. (See pp. 4-6.)

--Millions are written off annually simply because no reasonable effort is made to locate defaulting borrowers. (See pp. 7-8.)

--Liens are seldom obtained on assets owned by defaulting borrowers, such as the improved property. When liens are obtained, they are often allowed to expire due to HUD's failure to track expiration dates. Foreclosures are seldom, if ever, initiated on secured loans. (See pp. 16-21.)

--Defaulting borrowers are charged a lower effective interest rate on their loans after default than they were charged when their loans were current. This policy creates an incentive for current borrowers to default. (See pp. 22-24.)

--The Title I accounting system does not provide proper controls over such items as collections and inventory, and does not properly account for interest income. (See pp. 10-13, 23-25.)

CONCLUSIONS

Incomplete loan applications, wasteful management practices, outdated accounting systems, and inadequate collection practices contribute to the number of defaulted loans that go uncollected. Changes are needed to ensure aggressive loan servicing, remove rewards that encourage current borrowers to default, increase the use of legal remedies to obtain collections, and improve accounting methods.

RECOMMENDATIONS

GAO is making a series of recommendations (see pp. 14,20,25) to the Secretary of Housing and Urban Development aimed at alleviating accounting and loan servicing problems. Included are recommendations that the Secretary act to:

--Initiate systematic servicing of defaulted home improvement loans immediately upon receiving insurance claims from the lenders.

--Ensure, before writing loans off as uncollectible, that locator services have been used to find defaulting borrowers.

--Increase the use of legal remedies, such as obtaining liens on the improved properties to reduce uncollectible debts.

--Charge defaulting borrowers the maximum legally allowable interest rates.

AGENCY COMMENTS

HUD stated that increased emphasis is being placed on debt collection at the Department. As a result, collections on defaulted home improvement loans are estimated to be $15 million in fiscal 1982, which will represent the highest recoveries in the program's history. Additionally, the following actions, among others, have been taken or are in process which should further increase future collections.

--By mid-1982 HUD will supplement the collection efforts of its staff by using a private collection agency and will have operational an automated loan processing system to enable better accounting and more aggressive collection action.

--Title I lenders will be instructed to report defaulting borrowers to local credit agencies and regulatory changes will be implemented requiring all Title I loans to be secured at the time of the loan.

--The effective interest rate charged on defaulted loans will be increased.

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ABBREVIATIONS

FHA Federal Housing Administration

GAO General Accounting Office

HUD Department of Housing and Urban Development

IRS Internal Revenue Service

CHAPTER 1

TITLE I HOME IMPROVEMENT LOAN PROGRAM

The Title I Home Improvement Loan Program was established by the National Housing Act of 1934, as amended. One of HUD's oldest programs, it provides credit insurance on property improvement loans made by approved lending institutions. Since 1969 the program has also been used to finance the purchase of mobile homes. Loans are generally limited to a maximum of $15,000 ($30,000 for mobile homes) and must be repaid within 15 years (23 years on certain mobile homes). The maximum interest rate a lender can charge is set by HUD.

INSURED LOANS TOTALING OVER $30 BILLION HAVE BEEN MADE

Approved lenders must follow prudent lending practices in making loans and must pay HUD an annual insurance premium. HUD requires that loans of $7,500 or more be secured with a recorded lien on the improved property. However, about 80 percent of the loans made are for less than $7,500 and are usually unsecured.

Home improvement lenders are required to follow prudent lending practices and must either obtain a credit report on a loan applicant or perform a credit investigation before making a loan. Unlike other Federal housing programs, Title I individual loan applications are not reviewed by HUD at the time of approval unless the loan exceeds $15,000. Larger loans usually involve multiunit structures and such applications are sent to the local area office for prior approval.

HUD's role in Title I is to provide insurance against loan defaults. For that protection the lender pays annually about 1/2 of 1 percent (.5%) of the net proceeds of each loan reported for insurance. At default, the lender can submit a claim to HUD's central office in Washington. HUD pays 90 percent of a loss on loan proceeds, plus allowances as permitted by regulations such as lawyer fees and court costs. HUD also pays 90 percent of the interest at 7 percent per annum on the outstanding principal balance from the date of default to the date of application for reimbursement of loss, or for 9 months and 31 days after date of default, whichever is less.

HUD officials informed us that Title I program insurance premiums have traditionally exceeded program expenses. However, Title I formal financial statements are not available because the program is accounted for only as part of the Federal Housing Administration's (FHA's) general insurance fund.

Since inception of the program, HUD has insured over $30 billion in Title I loans and is currently insuring loans valued at over $1 billion annually. About 6,500 lenders are actively

participating in the program. Loans valued at about $633 million have resulted in claims for insurance with HUD. This represents a default rate since the beginning of the program of about 2 percent.

HUD IS RESPONSIBLE FOR COLLECTION OF DEFAULTED NOTES RETURNED BY LENDERS

Once the lender's claim is processed and paid, HUD headquarters submits the loan records to the area office for collection from the borrower. At the beginning of fiscal 1981 the loans were serviced by 57 Title I representatives in the HUD field offices. These representatives reported that they were servicing over 55,000 loans, or a caseload of about 1,000 loans per individual. The Title I representatives have the responsibility to contact and visit the borrowers in order to collect payments, negotiate payment plans, and, when necessary, recommend legal action. Legal actions include referring a loan to the Department of Justice to obtain a judgment against the defaulting borrower and, when the defaulted loan is secured, could include foreclosure on the improved property. The Title I representatives can also recommend that uncollectible loans be written off when legal actions do not appear warranted.

OBJECTIVES, SCOPE, AND METHODOLOGY

We reviewed HUD's servicing and accounting for defaulted Title I home improvement loans. Our objectives were to determine the effectiveness of current collection practices and determine if HUD's accounting system for defaulted home improvement loans conforms to sound accounting policies and procedures. To attain these objectives we:

--Discussed accounting and collection policies and procedures with responsible HUD officials.

--Reviewed the collection actions taken by HUD on defaulted loans in the New York and Chicago field offices.

--Selected a sample of defaulted loans written off during 1980 to determine if adequate actions were taken prior to writeoff.

--Reviewed HUD's accounting system for defaulted home improvement loans, which is maintained in HUD headquarters and supported by manual records in field offices.

We did not review loan origination practices of Title I lenders or verify the accuracy of the defaulted loans receivable balance.

Our work was performed at HUD headquarters in Washington, D.C., and at HUD's New York and Chicago area offices. New York

and Chicago were selected as audit sites because these two field offices service over 25 percent of the 55,000 defaulted home improvement loans in the inventory. We randomly selected 99 loans from the approximately 7,000 defaulted loans serviced by the HUD New York office and 70 loans from the 6,967 loans serviced by the HUD Chicago office during fiscal 1980. We reviewed these loans to determine:

1. How much time had elapsed between the time the loans were returned to HUD and HUD's first contact with the borrower.

2. How many loans in the New York and Chicago inventories of defaulted loans were being serviced under a payment plan.

3. How many defaulting borrowers serviced in HUD's New York and Chicago offices who had agreed to a payment plan were current in making their payments.

4. The extent of credit bureau reporting by lenders for the defaulted loans serviced in New York and Chicago.

We also reviewed a sample of 101 loans which had been randomly selected from approximately 1,000 loans written off as uncollectible in 1980 that were awaiting filing in a document room at HUD headquarters. These loans were reviewed to determine the extent of collection efforts prior to writeoff.

To determine if payment receipts were properly accounted for and controlled we reviewed 175 payment receipts. These receipts were not selected at random and the results are not projected.

Twenty-five secured loans valued at over $88,000 were reviewed to determine if loan records indicated that HUD, when necessary, had requested the Department of Justice to renew the liens securing the debt. These loans were selected by searching through defaulted loan cases at HUD headquarters until we found 25 secured loans. Because these loans were not randomly selected, the results noted in these cases cannot be projected.

To evaluate credit bureau reporting performed by lenders, we requested credit reports from one of the largest credit reporting agencies on 160 of the 169 loans in our New York and Chicago samples. Credit reports on nine borrowers in our sample were not requested because adequate identifying information on the borrower could not be found or the borrower was dead.

CHAPTER 2

AGGRESSIVE COLLECTION ACTION IS NEEDED TO REDUCE LOSSES RESULTING FROM UNCOLLECTIBLE DEBTS

When fiscal 1981 began, HUD had over $130 million in defaulted loans on hand and estimated that of this amount over $106 million would ultimately be uncollectible. This estimate, based on actual recent collection experience, projects that less than 19 cents of every dollar in defaulted loans on hand will be collected. It also reflects the high writeoffs of recent years. For example, during fiscal 1980 HUD wrote off loans valued at over $18.7 million--a noticeable increase over the writeoffs of $14.6 million in 1979 and $8 million in 1978.

Our review showed that collection of defaulted home improvement loans has been given low priority and has been ineffectively managed. Millions have been written off unnecessarily as uncollectible because HUD failed to aggressively pursue collection. In some cases loans were written off when the debtors refused to pay, even though the loan applications showed that assets or collateral were available. Specifically, we noted the following weaknesses:

--HUD has failed to contact borrowers promptly and initiate aggressive followup collection action.

--Many defaulted borrowers had no repayment plans or failed to meet the terms of repayment plans. These plans are required to be negotiated with HUD after defaulted loans are returned.

--Insufficient efforts have been made to locate defaulted borrowers before writing loans off as uncollectible.

--Credit bureaus have not been fully used to reduce program abuses.

--Accounting weaknesses have contributed to the lack of control over defaulted loans.

Using collection tools already available, HUD must begin to correct the many deficiencies we noted. Several bills are pending in Congress that, if enacted, would provide all Federal agencies, including HUD, additional collection tools such as the explicit authority to report defaulted borrowers to credit agencies.

HUD HAS FAILED TO TAKE TIMELY AND AGGRESSIVE COLLECTION ACTION ON DEFAULTED LOANS

The Federal Claims Collection Standards, which have been adopted by HUD in its regulations, require the head of an agency

or designate to take prompt, aggressive action, with effective followup, to collect all claims of the United States for money or property. We found that as a result of inadequate management attention HUD is not in compliance with these standards in servicing defaulted home improvement loans.

Loan servicing personnel in HUD's field offices have the responsibility to contact defaulting borrowers and arrange loan repayment plans. At the time of our review, detailed instructions on how to perform these collection duties were contained in a collection handbook published by HUD in 1963. We found, however, that this handbook was out of print and not provided to loan servicing personnel. HUD officials informed us that a new handbook existed in draft form and was undergoing departmental clearance. On July 10, 1981, the new handbook, which had been in some stage of preparation for over 10 years, was issued by HUD. Delays in publishing these procedures have contributed to loan servicing problems.

HUD's loan servicers have failed to contact defaulting borrowers promptly. Our review of 143 defaulted home improvement loans serviced in New York and Chicago showed it took HUD an average of 8.8 months from the time the loans were returned to HUD until the first contact with the borrower was initiated. In two cases it took HUD over 3 years. Delays of this length reduce the chances of collection since many borrowers sell their property, move, or declare bankruptcy. For example, about 8 percent of the defaulting borrowers serviced by HUD's New York field office sold the improved property before HUD could collect the debt or place a lien on the property.

It is imperative that defaulting borrowers not be allowed laxity in meeting agreed upon payments. If payment is not received after the prescribed set of payment notices are sent to a debtor, HUD requires special servicing in the form of personal contacts or specially prepared letters. The special followup letters are to be mailed at intervals most suitable to the status of the account, usually 10 to 15 days.

The following examples show delays that are occurring, contrary to the above procedures, in servicing some defaulted loans.

--One loan was returned to HUD in October 1976. In late 1976 a form letter was sent to the borrower. No further actions were taken in 1977, 1978, or 1979. As of December 1980, one more form letter had been mailed. In the more than 4 years that HUD had serviced the loan only those two form letters had been sent out. No payments had been received nor was the borrower under a payment plan.

--Another loan returned to HUD in September 1976 showed the borrower owed HUD over $2,300 in loan principal. From October 1976 to December 1980, four form letters were mailed

out. The borrower had no payment plan and made no payments during those 4 years. We noted that in the 3 years from 1977 to 1979, no servicing efforts were made.

Delays of this length in servicing loans can result in the debts becoming time-barred under the 6-year statute of limitations (28 U.S.C. 2415). Under that statute, judicial enforcement of a debt is barred once 6 years have passed without the borrower making a payment or acknowledging the debt in writing. The total number of defaulted loans that are beyond the 6-year statute of limitations is unknown.

MANY DEFAULTING BORROWERS HAVE NO PAYMENT PLANS

The Federal Claims Collection Standards require that, when possible, claims be collected in one payment. The Standards provide, however, that if the debtor is unable to make a lump sum payment, regular installment payments may be accepted, liquidating the debt in 3 years if possible.

HUD was unable to provide us the number of defaulted loans serviced under an agreed upon payment plan and the status of the payments under those plans. We estimate, based on our New York and Chicago samples of 169 defaulted loans, that 48 percent of the inventories in these two offices were not being serviced under a payment plan. Many borrowers without a payment plan had not made any payments to HUD. The chief of one Title I section explained that accounts were without payment plans because the section has been understaffed.

At the time of our review only 16 percent of the defaulted borrowers serviced in HUD's New York and Chicago field offices who had agreed to a payment plan were current under the plan. These agreements, which were not legally binding, were made by telephone, personal contact, or letter. They were informal in that they were not signed by both HUD and the borrowers and specified no time duration. The payment amounts were usually set without determining the financial position of the borrower and in most cases would extend the payback period far beyond the 3 years set forth in the Federal Claims Collection Standards. In some cases the payback period would exceed 20 years.

HUD procedures require that each time a personal contact is made with a borrower a field report must be prepared by the loan servicer. These field reports are important because they provide information on the debtor's assets and equity in real estate. We found few of these reports were properly completed by loan servicers. For example, only one of 99 defaulted loans in our New York sample contained a complete report. Without these reports, limited information is available to use in deciding on a payment amount or whether an account is uncollectible. More emphasis should be placed on determining the financial status of defaulting borrowers and placing borrowers under payment plans.

INSUFFICIENT EFFORTS HAVE BEEN MADE TO LOCATE DEFAULTING BORROWERS

Writing a loan off because a borrower cannot be found is justified only when locator services have been used to find debtors. However, at the time of our review HUD was not requesting addresses from the Internal Revenue Service (IRS) nor was it routinely requesting credit reports to serve as a locator aid. As a result many loans have unnecessarily been written off as "skips."

During fiscal 1980 HUD wrote off about 10,000 Title I loans as uncollectible. We reviewed a randomly selected sample of 101 from the approximately 1,000 uncollectible loans awaiting final filing in HUD's document room. Forty-three loans valued at $103,072 were classified as "skips." The borrowers had moved from the improved property, and routine post office tracers and/or other inquiries failed to provide new addresses. In our opinion, post office tracers are of limited value in locating defaulting borrowers. Even when borrowers report forwarding addresses, it is Postal Service policy to retain this information for about a year. Considering the long delay before servicing begins on defaulted loans, the value of these tracers is doubtful.

The following examples show how HUD's attempts to locate borrowers have often been inadequate.

- --A loan balance of over $4,400 was written off in July 1980 as a "skip." We noted the applicant gave his social security number on the original application and listed himself as an E-7 in the U.S. Army with 21 years service. Since the loan application showed the borrower's relatives as living in El Paso, Texas, we called the tollfree information telephone operator and obtained a telephone number for an individual with the same name living in El Paso. Despite the fact that HUD knew the applicant's social security number, which is a valuable locator aid, knew he was either active or retired military, and therefore receiving a government paycheck, and apparently could obtain a correct telephone number, HUD wrote the loan off as a "skip." A post office tracer had been used but was returned without a new address.

- --A loan in our New York sample was written off during our review as a "skip." We noted that 1 month after the loan was written off the borrower sent HUD a letter agreeing to pay $100 a month. The return address on the letter was the same as on HUD's records.

The IRS will provide to Federal agencies the last address of a debtor from tax records. This service, which has been available for years, is an inexpensive way to locate many defaulting borrowers. At the time of our review, HUD officials told us they did not use the service because it is of limited value. It requires use of the social security number and Title I borrowers are not required to give that number on loan applications.

Our New York and Chicago work revealed, however, that for about 77 percent of the cases reviewed, either the borrowers provided their social security numbers to the original lenders or we were able to obtain the numbers from a credit report. As a result, we concluded that the IRS locator service would be of value and should have been used in the past.

HUD's past failure to use this service has allowed possibly millions to be unnecessarily lost to the taxpayers. After we inquired about this matter, HUD established a contract to use the IRS service and to date has sent the IRS over 5,000 inquiries. We were informed that early results show better than an 80-percent identification rate.

Credit bureaus can also be helpful in locating "skips." Credit reports generated by these bureaus provide a history of an individual's debts and the payment status of the debts as reported to the credit bureaus by various lending institutions. When available data such as a name and date of birth are submitted to a credit bureau, the credit report often shows not only the borrower's address but the social security number as well. The social security number can then be sent to the IRS for further locator assistance if the address shown on the credit reports is not current.

HUD officials informed us that HUD has agreements with credit bureaus to obtain credit reports but does not request them routinely to locate borrowers. We believe that HUD's failure over the years to use credit reports to help obtain addresses and/or social security numbers has further allowed loans to be unnecessarily written off as "skips."

CREDIT AGENCY REPORTING SHOULD BE REQUIRED TO REDUCE PROGRAM ABUSES

Nationwide, thousands of borrowers have more than one home improvement loan in default. For example, about 14 percent of the defaulting home improvement borrowers serviced in HUD's New York and Chicago field offices had more than one loan in default. Based on our sample results we estimate that about 355 loans serviced in HUD's New York and Chicago field offices were owed by borrowers who obtained the loans after defaulting on other Title I loans. Many borrowers were able to obtain multiple loans by not reporting loans previously received on their loan applications.

Credit agency reporting is one way to reduce program abuses. Title I regulations generally prohibit a borrower from obtaining a loan if an existing obligation owed to, or insured by, any department or agency of the Federal Government is past due more than 15 days. Credit reports can be useful in identifying borrowers who fail to report previous loans on loan applications.

Credit agencies, however, now refuse to accept debt information from Federal agencies. This is because the Department of Justice has taken the position that acceptance of the information would make the credit agencies subject to the provisions of the Privacy Act. As a result, HUD cannot report defaulting borrowers to credit agencies. Home improvement lenders, however, can report loans to credit bureaus but are not required to do so by HUD. As a result, credit agency reporting by lenders is inconsistent and is not currently an effective means to prevent program abuses.

We requested credit reports from one of the largest credit bureaus for 160 defaulted borrowers. We received credit reports on one or more of the borrowers for 126 of the 160 defaulted loans. Based on our sample results we estimate for the total defaulted loans serviced in New York and Chicago that:

--5,911 credit reports (42 percent) did not show that the borrower ever obtained or was in default on a HUD home improvement loan.

--1,137 credit reports (8 percent) showed the Title I loan as a neutral factor. It appears the lenders reported the loan as neither a positive nor a negative factor, since the lender was paid by HUD.

--3,182 credit reports (23 percent) correctly showed the defaulted loan as a negative factor.

--For 3,766 loans (27 percent), credit reports were not requested and/or received.

The credit reports, therefore, showed the defaulted loans in our sample about 31 percent of the time. In 8 percent of the cases the defaulted loan appeared as a neutral factor. Consequently the requestor of the credit report must decide whether or not this is a bad or negative factor. Some of the borrowers, even though in default to the Government, had no negative factors at all on their credit rating and, barring other reasons, may be able to obtain additional loans.

Cases of multiple loans are too often discovered after the loan proceeds have been issued and the loans are in default. During our review we noted many examples of multiple defaulted loans by the same borrower. We identified one borrower who was able to obtain 10 Title I loans valued at over $50,000. After obtaining the 10th loan, the borrower defaulted on all the loans and HUD paid claims valued at over $28,000. A review of the 10 loan applications showed the borrower usually failed to list loans already received even though the loans were current as of the application dates. When the loans went into default the reason most often cited was financial difficulty.

We have previously reported cases of apparent fraud in this program. In 1957 we reported 1/ that borrowers were able to obtain multiple loans by submitting incomplete loan applications at different lending institutions. Since other cases of apparent fraud were found, we recommended that the Federal Housing Administration require lenders participating in the program within the same geographic region to share information on home improvement borrowers. FHA disagreed with our recommendation, stating that even though the sharing of data between lenders was desirable, FHA should not require such sharing in its regulations.

Consistent credit agency reporting by home improvement lenders would reduce the number of borrowers who are able to successfully falsify loan applications and obtain multiple Title 1 loans even after defaulting on earlier loans.

ACCOUNTING WEAKNESSES CONTRIBUTE TO THE LACK OF CONTROL OVER DEFAULTED LOANS

Internal control weaknesses allow HUD's accounting system to be vulnerable to fraud, waste, and abuse. Furthermore, those weaknesses have subjected the accounting system to numerous errors which impede effective collection practices. Specifically, we noted:

--Collections are not properly controlled or safeguarded.

--Payment receipts issued by loan servicers are inadequately controlled.

--The failure to perform required inventory reconciliations has resulted in inaccurate accounting records.

Section 113 of the Budget and Accounting Procedures Act (31 U.S.C. 66a), as amended, requires the head of each executive agency to establish and maintain systems of accounting and internal controls. This responsibility includes providing adequate assurance of the legality, propriety, and correctness of disbursements and collections of public funds.

Collections are not properly safeguarded

Cash and checks received through the mails or over the counter are inherently susceptible to loss, theft, or other misuse. Because of this, GAO's Policy and Procedures Manual for Guidance of Federal Agencies (7 GAO 11) specifies that agency collections should be placed under appropriate accounting and physical controls as soon as they are received. Such controls should, among other

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1/"Property Improvement Loan Insurance Program." H. Doc. 218, 85th Cong., 1st sess., July 31, 1957. Referred to the Committee on Government Operations.

things, provide for the cash and checks to be immediately logged and verified by an individual other than the one opening the mail. This establishes immediate control and provides a permanent check to determine whether all receipts are subsequently processed and deposited. The controls should also provide for use of prenumbered receipt forms that are properly safeguarded and accounted for.

Procedures currently followed in HUD's New York field office do not allow for the proper separation of duties necessary to maintain effective internal controls. We found that mail containing debtor payments in cash or checks was received and opened in the mailroom and then forwarded directly to Title I employees. The Title I employees who received these checks also credited debtors' accounts for payments made, prepared receipts, and made deposits. No separation of duties existed since the collections officer, who was responsible for maintaining a log of receipts, had photocopied her signature on blank collection register forms which were then filled out by other employees.

Payment receipts are not adequately controlled

Payment receipts that are issued to debtors for payments made are not adequately controlled. These receipts are especially important since HUD does not provide borrowers with periodic account statements. HUD procedures state that the care and control of official receipts is the responsibility of the Title I supervisor. The procedures also provide for inspection of receipts every 30 days. We noted during our review that this inspection was not being performed.

Our New York field office showed receipt books did not contain stubs showing to whom, when, or for how much a receipt was issued. Also, receipts issued were not always listed on the daily schedule of collections as required by HUD procedures. Furthermore, we found that one receipt book was signed out to two different people at different times without evidence that the first person had returned the book. Some receipts were unaccounted for while others were issued with no dollar amounts shown on them. Because HUD has not properly controlled these receipts and does not issue periodic account statements to borrowers, we believe that loan payments are susceptible to fraud.

Accuracy of accounting records is in doubt

HUD's failure to follow prescribed procedures has resulted in undetected errors in account balances. These errors result in differences between the area office and HUD headquarters loan balances. The current system provides only limited assurance that the collections reviewed in the field are properly recorded to debtors' accounting records.

Numerous errors exist in account balances. We found that HUD employees did not properly prepare internal control forms,

which should have detected most of the errors. Types of errors found included

--credit payments and charges not recorded to debtors' accounts,

--accounts credited and charged for the wrong amount,

--accounts credited twice for the same payment, and

--incorrect account numbers listed on receipts for payments.

These errors in HUD's accounting records have caused many differences between the area office and headquarters records. Nationwide, such differences exist in about 25 percent of the loans. Many of the discrepancies occurred because the area office listed the wrong account number on the receipt sent to the headquarters office; therefore, the headquarters office recorded credits and charges to the wrong debtor's account. As discussed in the next section, such differences have remained unresolved for years because periodic reconciliations have not been performed.

Errors of the magnitude found in this program place serious doubts on the credibility of HUD's accounting records for defaulted Title I loans. Immediate action should be taken to ensure that employees follow prescribed procedures. These actions should emphasize the strengthening of controls over collections and ensure that account balances between the area and headquarters offices agree.

Required inventory reconciliations have not been performed

HUD has not performed a complete inventory reconciliation of defaulted Title I loans since before 1972. Such reconciliations should be performed periodically. The failure to reconcile the loan accounting records has contributed to the situation we found, in which records are neither accurate nor in agreement between HUD headquarters and HUD field offices.

GAO's Policy and Procedures Manual (2 GAO 6) states that each agency's accounting control system should ensure the accuracy and reliability of its financial statements. Since Title I figures are reported in FHA's annual financial statements, balance discrepancies place doubt on the overall accuracy of those statements. Accounting problems such as these have resulted in our being unable in recent years to give opinions on HUD's financial statements.

In addition to different loan balances, many other computer exceptions have not been corrected. As of June 9, 1981, HUD's Title I mechanized records at headquarters had thousands of errors that needed to be corrected and posted. For example, almost 4,200

payments valued at over $577,000 had been received by HUD, considered to be Title I payments, but not researched and applied to an individual account. Some of these unresolved errors had been in HUD's computer system since 1973.

During 1978-1980, the unsupervised Title I Defaulted Notes Section was assigned temporary personnel. However, as of April 1981 the Reconciliation Group had only one permanently assigned person to reconcile account records. The failure to reconcile these records for years has resulted in a need for extensive reconciliation. However, given the extent and age of inventory differences a complete and accurate inventory reconciliation may not now even be possible.

Inventory problems in the Title I program have for many years been reported in HUD Inspector General audit reports. As recently as September 1980, the Inspector General reported 1/ that a complete reconciliation of the accounting records had not been performed since 1972. This report referred to an earlier 1978 report which also criticized HUD's failure to reconcile the inventory.

In past reports, we have criticized HUD's failure to perform inventory reconciliations. For example, on August 16, 1979, we reported 2/ that headquarters and field office records of single-family mortgages on hand did not agree. Requirements exist in Title I procedures which call for annual reconciliations. Furthermore, the procedures state that one of the functional responsibilities of the Title I Defaulted Notes Section is to reconcile the detailed trial balance with the records of the general ledger. HUD, however, has failed to adequately staff the Title 1 Reconciliation Group for the past 8 years. As a result, annual reconciliations were not performed. As one HUD official put it, "efforts to reconcile differences between the field offices and headquarters were almost nonexistent between 1972-78 due to low priority and lack of staff."

As a result of its Inspector General's most recent report, HUD developed the current inventory reconciliation plan. Since this extensive inventory of defaulted Title I loans was in process at the time of our review, we made no further effort to evaluate inventory problems.

1/HUD Inspector General, "Report on Examination of Selected FHA Insuring Fund Accounts, Fiscal Years 1977/1978."

2/"Weaknesses in Servicing and Accounting for Home Mortgages Held by HUD" (FGMSD-79-41).

PENDING LEGISLATION WOULD PROVIDE ADDITIONAL COLLECTION TOOLS

Various bills that would give agencies additional collection tools have been introduced in Congress and are supported by GAO. The proposed Debt Collection Act of 1981 (S. 1249), for example, would remove credit bureaus from Privacy Act requirements and restrictions. Credit bureaus could accept information from Federal agencies without making themselves subject to the Privacy Act. This would give agencies an additional collection tool--the ability to affect a borrower's credit rating. As discussed earlier, consistent credit bureau reporting could also be used to reduce program abuses.

Additionally, the legislation would require Federal agencies, including HUD, to report to the Office of Management and Budget on the status of debt collection efforts. These reports would provide collection data not currently available that could be used to evaluate agency collection efforts. Furthermore, passage of the bill would allow HUD to redisclose names, addresses, or social security numbers obtained from the IRS. The bill would also require Federal agencies to obtain social security numbers from loan applicants. Both of these provisions should assist Title I collection.

CONCLUSIONS

HUD has not met the requirements of the Federal Claims Collection Standards in servicing defaulted home improvement loans. Loan servicing has been inadequate and millions in debts that might have been collected have been written off as uncollectible.

Action should be taken to protect the Government's interest in unsecured loans. Home improvement lenders should be required to do more to reduce program abuses, while HUD should improve current accounting practices and ensure that aggressive servicing, including the use of locator services, is performed on all loans.

RECOMMENDATIONS

The Secretary of Housing and Urban Development should direct the Assistant Secretary for Housing and/or Administration to:

--Initiate systematic servicing of defaulted home improvement loans immediately upon receiving insurance claims from the lenders.

--Ensure, before writing loans off as uncollectible, that locator services have been used to find defaulting borrowers.

--Direct home improvement lenders to report all Title I loans and their status to credit bureaus and require lenders to obtain credit reports on loan applicants before making loans.

--Make full legal use of credit bureau reporting on loans in the current inventory, should pending legislation be enacted.

--Improve internal controls over receipts and accounting records by implementing controls already required in HUD procedures. Also, complete the current inventory reconciliation and thereafter reconcile periodically.

AGENCY COMMENTS

HUD stated that increased emphasis is being placed on debt collection at the Department. As a result, collections on defaulted loans are estimated to be $15 million in fiscal 1982, which will represent the highest recoveries in the program's history. Additionally, the following actions, among others, have been taken or are in process which should further increase future collections.

--By mid-1982 HUD plans to contract with a private collection agency to supplement the collection efforts of HUD staff. Under the proposed contract, the collection agency will receive loans that have been unsuccessfully worked by HUD loan servicers. When the contractor is unable to obtain payment, the loans will be returned to the Department where a decision will be made to write the loans off or refer them to the Department of Justice.

--HUD plans to implement an automated loan processing system by mid-1982. As currently planned, the new system will use an outside vendor to automate accounting for defaulted Title I loans and provide the information needed to more aggressively service the inventory.

--HUD plans to direct Title I lenders to report defaulting borrowers to local credit agencies.

CHAPTER 3

LEGAL ACTIONS ARE NEEDED TO COLLECT DEBTS

During fiscal 1980 HUD wrote off as uncollectible about 10,000 defaulted home improvement loans valued at over $18 million. These loans were usually written off without pursuing legal collection remedies. Specifically, we noted:

--Home improvement lenders seldom initiated legal action to secure the Government's interest before returning defaulted loans to HUD.

--HUD seldom referred defaulted loans to the Department of Justice to obtain liens on assets owned by defaulting borrowers, such as the improved property. Liens that were obtained were often allowed to expire.

--Foreclosures were seldom, if ever, initiated on secured loans in accordance with the requirements of the Federal Claims Collection Standards.

LENDERS SHOULD BE REQUIRED TO DO MORE TO PROTECT THE GOVERNMENT'S INTEREST

Unnecessary losses have been incurred by the Government because lenders seldom initiated legal action such as obtaining judgments and/or liens at the time of default. As a result, many borrowers sold their property without making payment, leaving HUD holding an unsecured signature loan. More frequent and earlier legal action should be taken by lenders to protect the Government's interest.

Home improvement loans for less than $7,500 make up about 80 percent of all Title I loans. These signature loans are not secured at the time of the loan. However, legal action can be taken subsequent to default, such as obtaining judgments against the borrower and placing liens on the improved property.

HUD procedures do not require lenders to pursue any legal collection remedies before filing an insurance claim. Claimants usually receive from HUD 90 percent of the loan balance due plus interest at 7 percent for up to 10 months after default. This gives lenders little incentive to pursue legal remedies or to file claims promptly. For example, the lenders in our Chicago sample did not return loans to HUD until an average of 10 months after default. Even though the loans are insured by the Government, we feel that prompt use of legal remedies after default constitutes a prudent lending practice and should be required of the lenders when assets exist and amounts owed exceed legal costs involved.

Lenders obtained judgments and/or liens on only about 5 percent of the defaulted loans returned to HUD in fiscal 1980. Even though HUD may ultimately stop pursuing collection on these loans, it will usually retain the lien on a borrower's property. If the property is subsequently sold, and the lien is still current, HUD may recover its debt.

Based on our sample discussed earlier, we estimate that 43 percent of the defaulting borrowers who had loans written off as uncollectible in fiscal 1980 had moved from the improved property. We also estimate that about 51 percent of these borrowers reported on their loan applications sufficient equity in the improved property to pay off the loans. Earlier legal action could therefore reduce losses.

One borrower in our sample of loans written off obtained a loan for $4,505 in May of 1977. The loan application showed that the borrower had $12,300 equity in the house and planned to use the money to install new plumbing and kitchen cabinets. The borrower defaulted on the loan in February of 1978 and an insurance claim was filed with HUD about 6 months later. Loan records showed no effort by the lender or HUD to obtain a judgment against the borrower or place a lien against the improved property. The loan was written off as a "skip" in 1980, after the HUD loan servicer learned the borrower had moved. If a lien had been placed on the property shortly after default, recovery of the debt may have been possible.

One HUD official stated that requiring lenders to take legal collection action before filing insurance claims would force many to stop participating in the program. Considering that the vast majority of unsecured loans do not go into default, we feel that requiring lenders to secure the Government's interest, when assets exist and loan balances exceed legal costs involved, is not an unreasonable requirement. Nor would it be excessively costly to lenders since HUD reimburses lenders for some legal costs incurred.

HUD SELDOM REFERS LOANS TO THE DEPARTMENT OF JUSTICE TO OBTAIN LIENS

When HUD is unable to obtain payment on defaulted loans, it can refer the loans to the Department of Justice for civil collection action such as obtaining judgments and/or liens. As discussed earlier, HUD loan records showed that many defaulting borrowers report on their loan applications sufficient equity in the improved property to cover the debt. However, few defaulted loans are referred to the Department of Justice for collection action after being returned to HUD.

HUD headquarters was unable to provide us with detailed nationwide statistics on the number and status of referrals made to the Department of Justice in recent years. Therefore, we visited the U.S. Attorneys in New York and Chicago to determine

the extent of the referrals made in these locations. Even though HUD's Chicago field office had an inventory of over 6,900 defaulted loans on hand, we found that Chicago's U.S. Attorney had only 25 cases that had been referred by HUD. All 25 cases were referred in 1980. No earlier referrals were found at the U.S. Attorney's office, even though HUD records in Chicago showed that about 200 other referrals had been made in past years and were pending legal action.

Some loans in our sample were written off because the borrowers either refused to pay or, in the judgment of the loan servicer, could not pay. Legal action, however, was not taken to collect the debt. For example, one borrower in our sample obtained in November 1978 a signature loan valued at over $4,200. In September 1980 the loan servicer wrote off this loan, stating the borrower refused to pay. No payments had ever been made; however, the loan application showed that the borrower owned a restaurant and made $500 a week. The improved property, listed as being purchased in 1972 for $60,000, had an unpaid mortgage of only $28,000. Despite the equity reported on the loan application and the borrower's apparent business interest, the loan was written off without obtaining a judgment or placing a lien on the property. Furthermore, the closing form indicated the borrower previously had two other home improvement loans written off. If legal action had been taken, collection would appear likely.

Another case in our sample illustrates abuses that occur in the program. The borrower obtained a Title I loan for $4,500 in March 1976 and defaulted without ever making a payment. After receiving a letter from an attorney stating the debtor was unable to pay, HUD wrote off the loan without obtaining a judgment or placing a lien on the property. Since the debtor reported on the loan application over $4,000 equity in the improved property, we contacted the local courthouse to determine the status of the property. We were informed that the debtor transferred ownership of the property to her two sons less than a month after applying for the loan. The transfer was made before the borrower signed the promissory note or received the loan proceeds. At least one of her two sons was, at the time of transfer, a minor. Approximately a year after the transfer the two sons sold the property for a profit.

Since HUD did not determine the status of the improved property prior to writing the loan off, this possibly fraudulent abuse of the program was not detected. HUD simply wrote the loan off, stating the borrower was unable to pay.

LIENS ARE OFTEN ALLOWED TO EXPIRE

State laws provide that liens placed on borrowers' property are valid only for a specified number of years but can be renewed. Therefore, the expiration dates of liens should be monitored and kept current to prevent the property from being sold without satisfying the debt.

Even though HUD may ultimately stop pursuing collection of a defaulted loan, it retains the lien on the borrower's property. If the property is sold, and the lien is still current, HUD may recover its debt. Therefore, HUD procedures require a system to be maintained to track the expiration dates of liens. We found, however, that no system was maintained and liens have been allowed to expire.

We reviewed 25 loans, valued at over $88,000, that had been returned to HUD in past years with liens obtained by the original lenders. The liens on three loans had already expired. One lien, on a loan valued at $3,237, expired in 1976. Furthermore, there was no indication in any of the 25 loan files of any action by HUD officials to get the Department of Justice to refile the liens. If the borrowers sell their properties and HUD has no valid lien, HUD probably will never collect its debt. Another 7 of the 25 loans valued at over $31,000 are due to expire within the next 2 years.

During our review of liens we found one borrower who defaulted on 13 loans valued at over $80,000. The loans were used to finance renovations on apartments owned by the borrower. When the borrower defaulted on the loans, HUD obtained 13 liens from the lender but failed to monitor the expiration dates. As a result, all 13 liens were allowed to expire. In most cases the borrower reported enough equity in the improved property to pay off the loans if the property were sold. Because HUD failed to renew the liens, determine the status of the property, or pursue any other collection activity on the debt, these loans will probably remain uncollected.

FORECLOSURE SHOULD BE USED, WHERE FEASIBLE, TO COLLECT DEBTS

HUD seldom, if ever, uses foreclosure as a collection tool. Its current practice of holding liens rather than initiating foreclosure action is not in compliance with the Federal Claims Collection Standards.

HUD procedures require that loans made for more than $7,500 must be secured at the time of the loan. Security is usually a lien placed on the improved property. If the borrower defaults on the loan and has sufficient equity in the property, HUD can refer the loan to the Department of Justice for foreclosure.

As discussed earlier, thousands of defaulted loans are written off annually. However, we found no cases where the Department of Justice was requested to foreclose. Nor did we find any justifications showing that the cost of foreclosure would exceed the expected debt recovery.

We realize that foreclosing on secured loans is not possible in many cases because the value of the property is not sufficient

to pay senior lien holders, satisfy homestead exemptions, allow for legal costs, and have funds remaining to liquidate the defaulted home improvement loan. However, HUD's current practice of not referring cases to the Department of Justice for possible foreclosure ignores a valuable collection tool and results in additional cost to the Government.

Given that the value of the property is sufficient, foreclosure is the ultimate collection tool for home improvement debts owed the Government. However, HUD officials informed us that, contrary to its written collection procedures, HUD will hold liens obtained on improved property rather than foreclose. HUD officials stated that if the improved property is ever sold and HUD holds a lien on the property, HUD will probably collect its debt since the lien must be satisfied for a buyer to obtain a clear title. We believe this practice is not in compliance with the Federal Claims Collection Standards.

We noted the following case where foreclosure appeared warranted but was not used. The borrower obtained a $10,000 home improvement loan in August 1975 to improve property owned but not lived in by the borrower. On the loan application the borrower listed over $40,000 in annual income, including monthly rental income, and about $8,500 equity in the property. Since the loan was for more than $7,500, the lender secured it by placing a mortgage on the property. After the borrower defaulted, HUD wrote off over $9,000 as uncollectible. The writeoff was classified as a "skip," and stated that the borrower moved to Florida and left no forwarding address. The servicing record did not show that any actions were taken to determine the status of the improved property, find out if a tenant was living in the property, or initiate foreclosure.

CONCLUSIONS

HUD has not made a responsible effort to pursue legal remedies to collect defaulted home improvement loans. This failure to use available legal remedies, such as obtaining liens and foreclosing on secured debts, increases the number of uncollectible loans. We believe that in cases of loan default both home improvement lenders and HUD should initiate aggressive legal actions to collect funds owed the Government.

RECOMMENDATIONS

The Secretary of Housing and Urban Development should direct the Assistant Secretary for Housing to:

--Determine a claim amount, based on such factors as legal cost involved, over which lenders will be required to obtain judgments and/or place liens on improved property before HUD pays an insurance claim.

--Require that, when financially feasible, defaulted loans be referred to the Department of Justice for collection action before the loans are written off as uncollectible.

--Establish a system to control and track the expiration dates of liens obtained by lenders or the Department of Justice.

--Establish and enforce foreclosure policies on secured loans in accordance with the Federal Claims Collection Standards.

AGENCY COMMENTS

HUD responded, in part, by stating that the following actions had been taken or were in process:

--A decision has been made which, when implemented, will require lenders to secure all Title I loans at the time of the loan. HUD plans to implement this requirement through a change in its regulations. February 1, 1982, is the date currently planned for the change to become effective.

--In July 1981 HUD delegated to its field offices the authority to refer cases directly to the Department of Justice without headquarters approval. This action should speed up the referral process while increasing the number of cases referred.

--The expiration date of liens obtained by lenders or the Department of Justice will be monitored by the automated loan processing system currently under development. HUD plans to implement this new system by mid-1982.

--HUD is currently studying the problem of foreclosing on secured defaulted Title I loans in order to establish a foreclosure policy.

CHAPTER 4

CHANGES ARE NEEDED IN INTEREST POLICY

TO REMOVE INCENTIVES TO DEFAULT

Changes are needed in HUD's Title I interest policy to accurately report interest income, charge realistic interest amounts on defaulted loans, and remove incentives that may encourage borrowers to default.

We noted the following problem areas:

--HUD reduces the interest rate on home improvement loans after default. This policy provides an incentive for current borrowers to default.

--Interest is recognized as income only when actually received. Therefore, amounts written off are understated since the interest earned is not reported.

POLICY OF REDUCING INTEREST PROVIDES INCENTIVE FOR CURRENT BORROWERS TO DEFAULT

HUD charges borrowers 6 percent or less interest after default. These interest rates have been used since about 1963 without revision to reflect legal maximums currently set by the States. Given current borrowing costs and the changes in maximum rates, HUD should revise its interest policy.

The maximum interest rate that approved lenders can charge on Title I loans is set by HUD and periodically revised as interest rates fluctuate. Lenders have been authorized to make Title I loans at interest rates up to 19 percent. However, should borrowers default on these loans, HUD will reduce the interest rate to 6 percent or less. This reduction in interest rates, which could be over 13 percent, provides a tremendous incentive to default. It also provides an incentive to make the payback period as long as possible since the funds are being lent at such favorable interest rates. Borrowers aware of HUD's policy can withhold payments intentionally, creating delinquency so that lenders will return the loans to HUD.

HUD officials informed us that 6 percent is charged because this is the amount New York State allows a lender to charge on a defaulted note. In an attempt to charge a uniform interest rate nationwide, 6 percent is used on defaulted loans in all but six States. In these six States the legal maximum rate in 1963 was under 6 percent. Therefore 5 percent or less is charged.

This policy rewards defaulting borrowers and may have even encouraged some borrowers to default. For example, our sample of 169 defaulted loans in HUD's New York and Chicago field offices

revealed that about 14 percent of the defaulting borrowers have more than one Title I loan in default. These borrowers and others may well be aware of the financial rewards possible from defaulting on a current loan.

Even though the legal maximum rate is still 6 percent in New York, most other States have increased legal rates to more realistically reflect the costs of borrowing. HUD should increase rates on defaulted loans to the greater of the amount specified in the original note or the legal maximum as set by the various States. Since the loans were originally made at different interest rates there is no valid justification to charge all defaulting borrowers at the same rate. This change would create no significant accounting problem since loan servicers currently compute interest manually.

METHOD OF APPLYING PAYMENTS FURTHER REDUCES EFFECTIVE INTEREST RATES

HUD's method of allocating monthly payments between principal and interest on defaulted loans further lowers the effective interest rate below the 6 percent rate usually charged on defaulted loans.

The Federal Claims Collection Standards require application of the "U.S. Rule" with respect to interest-bearing debts owed the United States. The regulations state, in part:

> "When a debt is paid in installments, the installment payments will first be applied to the payment of accrued interest and then to principal, in accordance with the so-called "U.S. Rule," unless a different rule is prescribed by statute, contract, or regulation." (4 C.F.R. 102.10)

However, HUD, under the provisions of the collection standards (24 C.F.R. 200.905), issued the following regulation on the method to be used to apply payments received on defaulted loans.

> "Where, in connection with a Title I claim assigned to the United States of America pursuant to 201.11 of this chapter, collection is made under a payment plan providing for regular installment payments, amounts received shall not be applied according to the so-called 'U.S. Rule' as prescribed in Section 102.10 [102.11] of the joint regulations of the General Accounting Office and the Department of Justice (4 C.F.R. 102.10) [102.11]. In such instances, amounts received shall be applied first to satisfy the principal of the debt. Subsequent payments shall be applied to the interest obligation, calculated on the basis of the declining principal balances without charging interest on interest balances." (24 C.F.R. 200.905)

We have previously reported on HUD's failure to apply payments under the U.S. Rule. In a March 14, 1979, report, 1/ we stated that defaulting borrowers of Section 312 rehabilitation loans were provided an unwarranted incentive to default since interest on defaulted loans was not computed under the U.S. Rule. This accounting method reduced the effective interest rate on rehabilitation loans from 3 to 2.3 percent. Subsequent to the report, HUD initiated action to implement the U.S. Rule method of applying payments on defaulted Section 312 loans. However, no change was made on the method of applying payments on defaulted Title I loans.

INTEREST IS RECOGNIZED AS INCOME ONLY WHEN ACTUALLY RECEIVED

Amounts written off are understated because HUD does not report the writeoff of the interest earned on defaulted loans. Under HUD's accounting method, interest is not recognized as income until received.

This accounting method, which is not in compliance with GAO's Policy and Procedures Manual for Guidance of Federal Agencies, also affects operating results, as reported in HUD's financial statements. The manual states:

> "The maintenance of accounts on the accrual basis is a basic requirement for Federal agencies. Achieving the primary objectives of Federal agency accounting set forth in the Budget and Accounting Procedures Act of 1950 requires the use of the accrual basis of accounting. Public Law 84-863, approved August 1, 1956, provides specifically that the head of each executive agency shall cause the accounts of his agency to be maintained on an accrual basis."

Estimated interest receivable on defaulted Title I loans is reported only as a footnote to FHA's combined financial statements. Therefore, accrued interest on defaulted Title I loans has no effect on operating results. Since interest is collected and, therefore, reported as income only after principal is reduced to zero, HUD's method of accounting delays the reporting of interest income. When loans are considered uncollectible and are written off, interest receivable is not written off since it has not previously been reported.

This method of accounting further violates our principles and standards in accounting for receivables. These standards state, in part:

1/"Action Being Taken to Correct Weaknesses in the Rehabilitation Loan Program" (FGMSD-79-14).

"Amounts receivable shall be recorded accurately and promptly on completion of the acts which entitle an agency to collect amounts owed to it. * * * Regular estimates shall be made from time to time of the portion of amounts receivable that may not be collectible. Such estimates shall be accounted for and disclosed separately."

HUD has on hand defaulted Title I loans valued at over $130 million. The failure to report the interest legally due on such a large amount has a significant effect on HUD's financial statements. Depending on the age of the loan, the interest receivable on some loans may be more than the principal balance due. Since all loans will not ultimately be written off, HUD's accounting method understates income to the fund by delaying its reporting date. This accounting method also understates amounts written off since the forgiveness of the legal obligation to pay interest is not recognized. Accrued interest should be reported as interest income. If collection of the interest is doubtful, the economic realities of the situation should be reported by the use of reserve accounts for estimated losses on interest receivable.

CONCLUSIONS

HUD's policy of reducing interest rates on defaulted loans rewards defaulting borrowers and may have encouraged some borrowers to default. Since rates are reduced to 6 percent or less and payments are not applied under the U.S. Rule, the reduction in effective interest rates can be over 13 percent. Borrowers aware of this policy can intentionally withhold payments to get their loans returned to HUD. Considering that many defaulting borrowers have more than one loan in default, these borrowers as well as others may well be aware of HUD's policy. Interest on defaulted loans should be reported as income when earned to more accurately report operating results and recognize the full costs of loans written off.

RECOMMENDATIONS

The Secretary of Housing and Urban Development should:

--Charge defaulting borrowers the maximum allowable interest rate and amend HUD regulations in order to apply payments received in accordance with the U.S. Rule.

--Increase the accuracy of financial reporting by computing and reporting interest on defaulted home improvement loans under accrual accounting methods.

AGENCY COMMENTS

HUD informed us that the Department plans to adopt the "U.S. Rule" and to increase the interest rate charged on defaulted loans. These actions, when implemented, should remove incentives that may have encouraged some borrowers to default.

SAMPLING RESULTS

PROJECTIONS TO UNIVERSE

Our review of the Title I home improvement loan program was based on a random sample of 169 defaulted home improvement loans serviced by HUD's New York and Chicago area offices. The sample results at the two locations were weighted so that they could be combined and projected to the universe of 13,996 defaulted loans serviced by New York and Chicago in 1980. These projections are included in table 1. We also reviewed a randomly selected sample of 101 unfiled loans written off as uncollectible in 1980. We projected selected characteristics of these loans to the universe of the 1,010 unfiled loans as shown in table 2.

Statistical sampling enables us to draw conclusions about a universe on the basis on information in a sample of that universe. The results from a statistical sample are subject to some uncertainty (sampling error) because only a portion of the universe has been selected for analysis. The sampling error consists of two parts: confidence level and range. The confidence level is the degree of confidence that can be placed in the estimates derived from the sample. The range is the upper and lower limits between which the actual universe value will be found.

For example, a random sample of defaulted loans showed that about 48 percent of them were not being serviced under a payment plan. Using a sampling error formula with a 95-percent confidence level, the true percentage of defaulted loans not being serviced under a payment plan would be within plus or minus 8 percent of the sample results. Thus, if all the defaulted loans in the universe were reviewed, chances would be 95 in 100 that the actual percent of defaulted loans without a payment plan would be between 40 (48-8) and 56 (48+8) percent. The upper and lower limits (range) for all estimates presented in the report are shown in tables 1 and 2.

Table 1
Projections of Sample Results to Title I Home Improvement Loans
Serviced by HUD's New York and Chicago Offices

Description	Universe estimate		Range (95% confidence)	
	Number	Percent	Number	Percent
Average time (months) it took HUD from the time defaulted loans were returned to HUD until first contact with the borrower was initiated	8.8	-	7.9 to 9.7	-
Borrowers with defaulted loans serviced by New York that sold property before HUD could collect the debt or place a lien on the property	568	8.1	193 to 943	2.7 to 13.4
Defaulted loans not being serviced under a payment plan	6,764	48.3	5,708 to 7.820	40.8 to 55.9
Borrowers with defaulted loans who agreed to a payment plan and were current under the plan	1,108	16.2	548 to 1,688	8.0 to 24.4
Defaulted loans in which borrowers provided social security numbers or numbers were obtained from a credit report	10,755	76.8	9,863 to 11,647	70.5 to 83.2
Borrowers with defaulted loans who had more than one loan in default	1,667	14.2	1,240 to 2,094	10.6 to 17.8
Defaulted loans in which borrowers obtained loans after defaulting on earlier loans	355	2.5	54 to 656	0.4 to 4.7
Credit reports that failed to show that the borrowers were in default on HUD home improvement loans	5,911	42.2	4,826 to 6,960	34.7 to 49.7
Credit reports that showed the defaulted loan as a neutral factor	1,137	8.1	562 to 1,712	4.0 to 12.3
Credit reports that showed the defaulted loan as a negative factor	3,182	22.7	2,364 to 4,000	16.9 to 28.6
Cases in which no credit report received or requested	3,766	26.9	2,824 to 4,708	20.2 to 33.6
Credit reports that showed defaulted loans	4,318	30.9	3,401 to 5,235	24.3 to 37.5

Table 2
Projections of Sample Results to 1,010 Title I Home Improvement Loans
Written Off As Uncollectible

Description	Universe estimate		Range (95% confidence)	
	Number	Percent	Number	Percent
Defaulted loans in which borrowers had moved from improved property and post office tracers and inquiries failed to locate borrower	430	42.6	338 to 552	33.5 to 51.7
Defaulted loans in which borrowers had moved from improved property but reported on their loan applications that they had sufficient equity to pay off the loans	220	51.2	143 to 297	33.3 to 69.1

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WASHINGTON, D.C. 20548

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