United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Oversight and Investigations, House Financial Services Committee, House of Representatives

For Release on Delivery
Expected at
10:00 a.m. EDT
Monday
September 10, 2001

HOMEOWNERSHIP

Problems Persist With HUD's 203(k) Home Rehabilitation Mortgage Insurance Program

Statement of Stanley J. Czerwinski
Director, Physical Infrastructure Issues

GAO

Accountability * Integrity * Reliability

Madame Chairwoman and Members of the Subcommittee:

We are here today to testify on the Department of Housing and Urban Development's (HUD) 203(k) Home Rehabilitation Mortgage Insurance Program. The 203(k) program was established to help promote the rehabilitation and repair of housing through a program that combines, in one insured mortgage, the funds needed to purchase and rehabilitate a single-family home. The loans are made by banks and other private lenders from their own funds and are insured by HUD's Federal Housing Administration (FHA). The 203(k) program has a history of waste, fraud, and abuse that resulted in our review of HUD's oversight of the program approximately 2 years ago.[1] My testimony today will summarize the findings and recommendations of our report as well as HUD's actions on our recommendations since the report was issued.

In summary, our work showed:

- The 203(k) program is inherently more risky than HUD's principal single-family loan insurance program because its rehabilitation component makes it more complex and susceptible to misuse. HUD's Inspector General and others have noted such risks in 1997 and 1998 reports on the department's management of the program.
- HUD was not adequately targeting 203(k) loans and lenders for review, properly training and overseeing consultants/inspectors, and monitoring nonprofit organization's participation in the program. HUD has implemented three of the four recommendations we made to address these three areas.

Background

The 203(k) Home Rehabilitation Mortgage Insurance Program is HUD's primary program for rehabilitating and repairing single-family homes.[2] Because loans insured under this program have characteristics of both home purchase and construction loans, lenders who want to get a loan insured under the 203(k) program must follow a more complex process to approve and disburse the loans than they would under FHA's other mortgage loan insurance programs. The program provides borrowers the

[1] *Homeownership: Problems Persist with HUD's 203(k) Home Rehabilitation Loan Program* (GAO/RCED-99-124, June 14, 1999)

[2] The Rehabilitation Home Mortgage Insurance program was authorized by section 203(k) of the National Housing Act, as amended, 12 U.S.C. 1709(k).

convenience of financing both the purchase or refinancing of a house and the cost of its rehabilitation through a single mortgage. Eligible borrowers may include the owner/occupant, nonprofit organizations, and investors, although there has been a moratorium on investors' eligibility since October 1996.[3] The program protects lenders against financial losses by insuring a loan for the full value of the rehabilitated home before the rehabilitation process begins. If the borrower defaults and the lender subsequently forecloses on the loan, the lender can file an insurance claim with HUD for the unpaid balance of the loan.

Although the 203(k) program was established in its present form in 1978, it was not widely used until 1994, when HUD began promoting and streamlining the program to make it more user-friendly for borrowers and lenders. As a result of these efforts, the number of 203(k) loans that HUD insured grew from about 4,000 in fiscal year 1994 to over 18,000 in fiscal year 1997. From this peak, the number of insured 203(k) loans fell to about 10,000 in fiscal year 2000. As of July 31, 2001, the total value of HUD's 203(k) portfolio was approximately $4.5 billion.

The 203(k) Program Design Is Inherently Risky

The 203(k) program poses inherent risks because it is much more complex than HUD's largest single-family loan program, the 203(b) program. The 203(k) program's complexity stems from the rehabilitation component of the program, which (1) relies heavily on estimates, reports, and opinions; (2) has many underwriting and funding steps; and (3) involves participants other than the borrower and the lender. For example, to close a 203(k) loan, a lender must set-aside in an escrow account the estimated funds to pay for the rehabilitation. A HUD-approved consultant is often needed to determine the extent of work that must be done to rehabilitate a property and the estimated cost of that work. In addition, a HUD-approved inspector is needed to monitor the progress of the rehabilitation and co-sign with the borrower any request of escrow funds.

The program's high degree of risk is also reflected in the poorer performance of 203(k) loans compared with loans made under the 203(b) program—HUD's largest single-family loan program. For example, for loans made from fiscal years 1994 through 1996, we found that as of September 30, 1998, the cumulative claim rates for 203(k) loans were

[3] Because of abuses by investors in the program, a moratorium on investor participation was implemented in October 1996.

almost double the rates for 203(b) loans. A claim results when a loan goes into default and results in a claim being filed against the insurance fund. In addition, we found that the 203(k) program was expected to incur net losses of over $25 million for loans insured in fiscal years 1994 through 1998, while the 203(b) program was expected to incur net gains for the same period. Consistent with these findings, a 1998 study by HUD contractors asserted that the 203(k) program posed a high risk of loss to the department and that this risk had been reflected in high default and claim rates.

Program Risk Noted in Studies

Both internal and outside reviews of the 203(k) program have concluded that under its current design, the program is susceptible to a variety of problems. For example, HUD's Inspector General reported in 1997 that the program's design encouraged risky property deals, overstated property appraisals, and phony or excessive fees. In addition, an internal HUD study of the 203(k) program identified several inherent program risks, including the failure of participants to accurately estimate the cost of rehabilitation or to complete rehabilitation work in an acceptable manner.

We also found that outside reviews of the 203(k) program concluded that under its current design, the program is susceptible to a variety of problems. For example, in October 1998, contractors hired by HUD to study the 203(k) program reported that the department had done little to reduce the risks of the program. The contractor's draft report identified several major risks associated with the 203(k) program, including program complexity, insufficient lender monitoring, inadequate guidance concerning consultants, hesitant management direction, and increased loss potential from nonprofit organizations.

HUD's Oversight of the 203(k) Program Was Inadequate

During our 1999 review, we found that HUD had not implemented the oversight procedures necessary to mitigate the 203(k) program's unique risks and potential for abuse. Specifically, we found that HUD was not (1) adequately targeting 203(k) loans and lenders for review, (2) properly training and overseeing consultants and home inspectors, and (3) adequately monitoring nonprofit organizations' participation in the program.

HUD's four homeownership centers are responsible for the general management of the 203(k) program in their respective regions. The centers perform technical reviews—desktop audits of loans already insured by FHA—to determine the quality of underwriting for specific loans. They also conduct quality assurance reviews—in-depth reviews of a lender's troubled loans and internal control systems for originating loans—to assess the lenders' performance and operations. Although HUD was aware of the high-risk nature of the 203(k) program, we found that the homeownership centers did not target 203(k) loans for technical reviews. Furthermore, concerning the 203(k) loans they did review, they did not send the detailed results of their evaluations to the lenders. Consequently, the lenders did not have the information necessary to act on the problems that were uncovered by HUD's review. We recommended that HUD improve its identification of lenders' underwriting violations, as well as its notification and penalization of lenders who commit underwriting violations. HUD has not completed action on this recommendation. HUD, however, is in the process of hiring a contractor to review the results of its desk reviews of 203(k) lenders and develop criteria for assessing the risks associated with 203(k) lenders.

We also found that while the homeownership centers had conducted quality assurance reviews of lenders participating in the 203(k) program, they did not specifically target 203(k) loans for review. Officials at two of the centers said they felt that they did not have staff who were qualified to evaluate a lender's underwriting of 203(k) loans. Furthermore, HUD was unable to tell us how many 203(k) loans had been examined as part of its quality assurance reviews. We recommended that HUD target high-risk 203(k) lenders for quality assurance reviews. In response, HUD issued specific procedures in May 2000 for identifying high-risk 203(k) lenders and targeting them for annual monitoring.

Although consultants and inspectors are key participants in the 203(k) program, we found that HUD had no uniform criteria for their training, approval, or evaluation. Consultants and inspectors are used to perform home inspections, identify health and safety problems, and provide descriptions of the work to be performed and cost estimates for homebuyers. In addition to having at least 3 years of specialized experience, consultants and inspectors must receive training in the 203(k) program. However, at two of the four homeownership centers we visited, HUD had not trained any 203(k) consultants and inspectors. In addition, three of the four centers had not evaluated the performance of their consultants or inspectors. Finally, we also found cases in which HUD failed to address consultants' abuses or incompetence. For example, according to customer complaints we reviewed, a 203(k) inspector in Chicago allowed a contractor to receive thousands of dollars for work that the contractor either did not do or did inadequately. We recommended that HUD establish strict criteria to ensure that consultants/inspectors are well versed in residential construction/rehabilitation and cost estimating. In response, HUD issued guidance on July 26, 2000, that sets new standards and procedures for 203(k) consultants participation in the program.

Although approved nonprofit organizations can obtain 203(k) loans, we found that HUD was not adequately ensuring their compliance with HUD's guidelines for participating in the program. HUD's guidelines require the homeownership centers to recertify nonprofit organizations every 2 years. However, at three of the four centers we visited, we found no evidence that the centers had recertified any of their approved nonprofit organizations. Loans to nonprofit organizations represent a small portion of the 203(k) program, but the performance of these loans has been significantly worse than for any other borrower type in the 203(k) program. We recommended that HUD establish strict criteria for qualifying and recertifying nonprofit organizations for their continued participation in the program. In response, HUD issued guidance on March 3, 2000, that sets uniform standards for nonprofit agencies participation and recertification in all FHA activities.

In beginning to implement our recommendations, HUD has taken some positive steps toward tightening its control over the 203(k) program. However, the inherent risk of this program means that the program requires continued management attention and further improvements in oversight.

Madame Chairwoman, this concludes our prepared statement. We are happy to answer any questions that you or Members of the Subcommittee may have.

Contact and Acknowledgments

For future contacts regarding this testimony, please contact Stanley Czerwinski or Paul Schmidt at (202) 512-2834. Individuals making key contributions to this testimony included Paige Smith, Richard Smith, Steve Westley, and Alwynne Wilbur.

Orders by Internet

For information on how to access GAO reports on the Internet, send an e-mail message with "info" in the body to

info@www.gao.gov

or visit GAO's World Wide Web home page at

http://www.gao.gov

To Report Fraud, Waste, and Abuse in Federal Programs

Web site: http://www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: 1-800-424-5454