



Office of Single Family Housing, Washington, DC

Oversight of FHA-Insured Loans in Flint, MI



To: Robert E. Mulderig, Acting Deputy Assistant Secretary for Single Family Housing, HU
From: //signed//
David E. Kasperowicz, Regional Inspector General for Audit, Philadelphia Region, 3AGA
Subject: HUD Did Not Ensure That Lenders Verified That FHA-Insured Properties in Flint, MI, Had Safe Water

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's oversight of Federal Housing Administration (FHA)-insured loans in Flint, MI.

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 8M, 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 215-430-6734.



Audit Report Number: 2016-PH-0003

Date: July 29, 2016

HUD Did Not Ensure That Lenders Verified That FHA-Insured Properties in Flint, MI, Had Safe Water

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) oversight of Federal Housing Administration (FHA)-insured loans in Flint, MI. We conducted the audit based on recent news reports that identified high levels of lead contamination and because HUD had insured loans on properties in Flint that closed after the City of Flint began using the Flint River as its water source in April 2014, including 144 loans with unpaid balances totaling \$11.2 million that were endorsed after the health department first declared a public health emergency on October 1, 2015. Our audit objective was to determine whether HUD ensured that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water.

What We Found

HUD did not ensure that lenders verified that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water. Specifically, 11 of the 17 files reviewed did not contain evidence of water testing to show that the water was safe, and subsequent testing performed by the State of Michigan showed that at least 4 of the 11 properties had lead and copper levels above the Environmental Protection Agency's action levels. This condition occurred because HUD's existing controls were not designed to specifically detect whether the loan files contained evidence of water testing. The issues identified represent an ongoing safety concern. Further, HUD and homeowners also face an increased risk of loss if property values decrease due to the water safety issues, and homeowners may not have sufficient resources needed to attain and maintain safe water.

What We Recommend

We recommend that HUD direct the applicable lenders to provide evidence showing that the properties had a safe and potable water source at the time the loans closed and were endorsed, or, if the lenders cannot provide this evidence, direct them to perform water testing and any necessary remediation to ensure that the properties currently have a safe and potable water source, or indemnify HUD against any future loss, thereby putting up to \$10.8 million to better use. We also recommend that HUD take appropriate administrative action against the parties involved for any cases where they did not take appropriate steps to ensure that properties in Flint, MI, had a safe and potable water source, and improve its controls to ensure that it does not insure additional loans in Flint for properties that do not have a safe and potable water source.

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Background and Objective

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, insuring more than 34 million properties since its inception in 1934. The FHA became part of the U.S. Department of Housing and Urban Development (HUD) in 1965. HUD's single-family housing programs include mortgage insurance on loans to purchase or refinance new or existing homes. Because HUD insures the loan, lenders are able to offer borrowers low downpayments and low closing costs.

To be eligible for an FHA-insured loan, borrowers must meet certain credit qualifications. Additionally, the properties must meet minimum property requirements. HUD Handbook 4000.1, section II, paragraph A.3.a.ii(F)¹ establishes standards and provides guidance on minimum property requirements, including that properties have a sufficient supply of safe and potable water.² Further, regulations at 24 CFR (Code of Federal Regulations) 200.926d(f) state that properties must contain a safe water supply and 24 CFR 203.52 discuss requirements for loans on properties where public water systems do not meet basic requirements.

The Safe Drinking Water Act requires the Environmental Protection Agency (EPA) to determine levels of contaminants in drinking water at which no adverse health effects are likely to occur. The EPA has set the maximum contaminant level goal for lead in drinking water at zero because lead is a toxic metal that can be harmful to human health even at low exposure levels. It has set the maximum contaminant level goal for copper at 1,300 ppb (parts per billion). The EPA also sets enforceable standards known as action levels for lead and copper, which are the highest levels of the contaminants allowed in drinking water. Regulations at 40 CFR 141.80(c)³ state that the action levels are exceeded if the concentration of lead or copper in more than 10 percent of tap water samples collected is greater than 15 ppb of lead⁴ or 1,300 ppb of copper. According to the EPA, exposure to lead in drinking water may cause cardiovascular issues, increased blood pressure, decreased kidney function, and reproductive problems in adults. Infants and children are at risk of behavior and learning problems, lower IQ's, hyperactivity, slowed growth, hearing problems, and anemia. Further, both the EPA and the Centers for Disease Control and Prevention agree that there is no known safe level of lead in a child's blood. Exposure to copper in drinking water may cause gastrointestinal distress as well as liver or kidney damage.

Recent news reports have identified water quality issues across the country, including high levels of lead in Flint, MI. The contamination in Flint is believed to be a result of the City of Flint's switching its water supply to the Flint River on April 25, 2014, which it did as a cost-saving

¹ HUD Handbook 4000.1 was implemented on September 14, 2015. This handbook superseded Appendix K of HUD Handbook 4910.1, which contained the same guidance.

² Potable water is water that is suitable for drinking.

³ The EPA publishes the action levels in 40 CFR 141.80(c).

⁴ While the EPA acknowledges that lead is harmful at low exposure levels and sets the maximum contaminant goal at zero, it also sets an action level that is enforceable.

measure. While residents began to complain about the water quality by June 2014 and reported health issues such as rashes, hair loss, and slowed growth in children, officials from the City and the Michigan Department of Environmental Quality stated that the water was in compliance with Federal and State standards as recently as September 2015. However, on October 1, 2015, the Genesee County Health Department declared a public health emergency and issued a “do not drink” advisory. Since then, several additional emergency declarations have been made, including declarations by the City on December 14, 2015, the Genesee County Commission on January 4, 2016, the State of Michigan on January 5, 2016, and President Obama on January 16, 2016.

As of March 25, 2016, the State had tested 16,955 water samples from residential properties. Of the 16,955 samples, 1,305 samples had tested above the EPA action level for lead, and 78 samples had tested above the EPA action level for copper. The table below shows the lead testing results from the State.

Lead ppb	Number of samples collected	Percentage of samples collected
0	8,465	49.93
1-15	7,185	42.37
16-50	829	4.89
51-149	292	1.72
> = 150	184	1.09
Totals	16,955	100

As of March 31, 2016, HUD had more than 13,362 actively insured loans in Genesee County, including 4,701 loans for properties located in Flint.⁵ Since April 25, 2014, when the City switched its water source to the Flint River, HUD had endorsed 616⁶ loans for properties in Flint with unpaid balances totaling \$45.8 million. Of the 616 loans, 144 were endorsed after the health department first declared a public health emergency on October 1, 2015. The unpaid balances for these 144 loans total more than \$11.2 million. In February 2016, HUD issued a question and answer document that recognized the water contamination crisis in Flint and reminded lenders and other stakeholders involved with FHA transactions of the requirements for properties to be eligible for insurance. The guidance stated that if a property was located in an area serviced by an unacceptable water system with unacceptable levels of contaminants, including lead, a water test must be completed.

Our audit objective was to determine whether HUD ensured that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water.

⁵ This includes loans that were closed before April 2014, when Flint switched its water supply to the Flint River.

⁶ HUD had endorsed 616 loans as of March 10, 2016. Note that this did not include streamline refinances because they do not require an appraisal.

Results of Audit

Finding: HUD Did Not Ensure That Lenders Verified That FHA-Insured Properties in Flint Had Safe Water

HUD did not ensure that lenders verified that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water. Specifically, 11 of the 17 files reviewed did not contain evidence of water testing to show that the water was safe, and subsequent testing performed by the State showed that at least 4 of the 11 properties had lead and copper levels above the EPA action levels. This condition occurred because HUD's existing controls were not designed to specifically detect whether the loan files contained evidence of water testing. Further, while HUD took steps to remind lenders and appraisers of the requirements after the President signed the emergency declaration in January 2016, it did not always document its efforts and did not proactively reach out to individual lenders. The issues identified represent an ongoing safety concern for homeowners and household members. HUD and homeowners also face an increased risk of loss if property values decrease due to the water safety issues, and homeowners may not have sufficient resources needed to attain and maintain safe water. If HUD directs the lenders for the 11 loans reviewed and the additional 127 loans not selected for review to provide evidence showing that the properties had a safe and potable water source at the time the loan closed, or, if the lenders cannot provide this evidence, directs them to perform water testing and any necessary remediation to ensure that the properties currently have a safe and potable water source, or indemnify HUD against any future loss, it could put up to \$10.8 million to better use.

Loan Files Did Not Always Contain Evidence of Water Testing

Loan files did not contain evidence to show that the properties had safe and potable water. Regulations at 24 CFR 200.926d(f) and HUD Handbook 4000.1, section II, paragraph A.3.a.ii(F)⁷ state that properties are required to have a continuing and sufficient supply of safe and potable water. We reviewed 17 loan files related to properties located in Flint⁸ to determine whether the files contained evidence that the water was safe. Of the 17 loan files reviewed, only 6 contained evidence of water testing and showed that the water was not contaminated. The files for the remaining 11 loans did not contain evidence of water testing. As a result, HUD did not have assurance that the properties for the 11 loans, with unpaid balances totaling \$786,398, had a continuing and sufficient supply of safe and potable water.

⁷ HUD Handbook 4000.1 was implemented on September 14, 2015. This handbook superseded Appendix K of HUD Handbook 4910.1, which contained the same guidance.

⁸ Fifteen of the 17 loans closed after the health department first declared a public health emergency on October 1, 2015, and all 17 loans were endorsed after October 1, 2015. The closing date is the date the property sale or refinance was final, and the endorsement date is the effective date of the FHA mortgage insurance.

Water Testing Performed by the State Showed That HUD Insured at Least Four Properties With High Levels of Lead and Copper

HUD insured at least four properties that had lead and copper levels above the EPA action level. Regulations at 40 CFR 141.80(c) state that the action level is exceeded if tap water samples contain more than 15 ppb of lead or 1,300 ppb of copper. The properties for 4 of the 11 loans discussed above were subsequently tested by the State⁹ and had lead and copper levels exceeding the EPA action levels. The lead levels for the 2 most egregious cases were 254 ppb and 746 ppb, the latter of which is almost 50 times higher than the EPA action level. The table below shows the results of the water testing conducted by the State.

Case number	Closing date / endorsement date	Results of water testing by the State	Date of water testing by the State	Unpaid balance
262-2192537	6/19/2015 / 1/4/2016	Lead – 28 ppb Copper – 5,430 ppb	1/26/2016	\$26,187
262-2223129	8/20/2015 / 2/2/2016	Lead – 22 ppb	3/15/2016	58,433
262-2234269	10/16/2015 / 11/2/2015	Lead – 746 ppb Copper – 1,520 ppb	2/2/2016	52,617
262-2246398	12/22/2015 / 1/28/2016	Lead – 254 ppb ¹⁰	2/17/2016	78,334
Total				\$215,571

While the State’s testing was performed after the loans closed and were endorsed, the lenders may have detected the water contamination issues if they had tested the water. The loans for these four properties had unpaid balances totaling \$215,571.

HUD Did Not Have Adequate Controls in Place To Ensure That Lenders Followed Applicable Requirements

The conditions described above occurred because HUD did not have adequate controls in place to ensure that lenders followed all applicable requirements when approving loans for properties located in Flint. While HUD had several controls in place, such as its post endorsement technical review and regular monitoring review processes, these controls were not designed to specifically address the issue of required water testing of properties in areas serviced by a public water system with known issues. For example,

- The regular endorsement process was not designed to specifically detect whether the loan files contained evidence of water testing. Loans that are insured through the Lender

⁹ In each of the four cases, the water testing performed by the State took place after the loan had closed and was endorsed for FHA mortgage insurance.

¹⁰ The property has since tested below 15 ppb for lead, although we do not know whether remediation was performed on the property to address the initial test results.

Insurance Program¹¹ are not reviewed by HUD before endorsement. While loans that are not insured through the program are reviewed by a HUD contractor before endorsement to check for the presence of certain documents, the contractor does not check for evidence of water testing.

- HUD's post endorsement technical review process was not designed to specifically detect whether the loan files contained evidence of water testing. Rather, the review forms were designed to identify whether the appraisal had noted any problems with the individual water supply system or indications of unsafe, unsanitary, or unsound living conditions. Further, the process used to select loans for review¹² did not require HUD to review any loans for properties located in Flint that closed after October 1, 2015.
- HUD's regular monitoring process was not designed to specifically detect whether the loan files contained evidence of water testing. The Quality Assurance Division's Desk Guide did not include steps to verify that lenders followed requirements to ensure that properties had a safe and potable water source. Further, while the Single Family Loan Review Basis for Ratings guide contained a finding code for properties that did not meet minimum property requirements or standards, there were no examples regarding water contamination issues. Finally, while HUD had performed two reviews after October 1, 2015, for lenders that had approved loans for properties located in Flint since the first emergency declaration, its findings did not discuss water contamination issues.

HUD Began To Take Steps To Remind Lenders and Appraisers of the Requirements

After the President signed an emergency declaration on January 16, 2016, HUD took several steps to remind lenders and appraisers of the applicable requirements. For example, in February 2016, HUD issued a question and answer document about the contamination in Flint to recognize the presidential declaration of emergency. The document reminded lenders and other stakeholders of the requirements for properties to be eligible for FHA mortgage insurance and of the need for water testing for properties located in areas serviced by public water systems with unacceptable levels of contaminants. Before the development of this document and related summary sheet, HUD did not have specific guidance for its FHA Resource Center to use when answering inquiries about public water contamination issues.¹³ While HUD stated that it also discussed the contamination in Flint during its regular appraiser and underwriter training held in Detroit, MI, in March 2016, the course materials did not address this topic¹⁴ and it did not provide documentation detailing the discussions. Further, HUD did not proactively reach out to

¹¹ The Lender Insurance Program allows high-performing lenders to self-insure certain FHA loans without a pre-endorsement review by a HUD contractor.

¹² The process used to select loans for post endorsement technical reviews considered several factors, such as the type of loan and whether the borrower had failed to make payments. It also included a random selection component and allowed HUD to manually select certain loans for review, including loans on which it had received a lender, borrower, or public complaint. As of March 2016, no loans on properties located in Flint that closed after October 1, 2015, had been selected for review.

¹³ The FHA Resource Center received several dozen inquiries from lenders regarding the water contamination issues in Flint.

¹⁴ The appraiser presentation only discussed the need for inspections of well and septic systems, and the underwriter presentation only contained references to the conditional commitment direct endorsement statement of appraised value.

lenders when the Genesee County Health Department first declared a public health emergency on October 1, 2015.

Conclusion

HUD did not ensure that lenders verified that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water. This condition occurred because HUD's existing controls were not designed to specifically detect whether the loan files contained evidence of water testing. Further, while HUD took steps to remind lenders and appraisers of the requirements after the President signed the emergency declaration, it did not always document its efforts and did not proactively reach out to individual lenders. The issues identified represent an ongoing safety concern for homeowners and household members. HUD and homeowners may also face an increased risk of loss if property values decrease due to the water safety issues, and homeowners may not have sufficient resources needed to attain and maintain safe water. If HUD works with the applicable lenders to ensure that the subject properties for these 11 loans have a safe and potable water source or the lenders perform any necessary remediation or indemnify HUD against future loss, up to \$786,398 could be put to better use.

Further, because 11 of the 17 loan files reviewed did not contain evidence of water testing and at least 4 of the related properties subsequently tested by the State showed high lead and copper levels, we believe that additional loan files may not contain evidence of water testing and the related properties may have high levels of lead and copper. Specifically, since October 1, 2015, HUD had insured 99 additional loans that closed after October 1, 2015, and 28 loans that closed before October 1, 2015. If HUD works with the applicable lenders to ensure that the subject properties for these additional 127 loans¹⁵ have a safe and potable water source or the lenders perform any necessary remediation or indemnify HUD against future loss, up to \$10 million could be put to better use.

Recommendations

We recommend that the Acting Deputy Assistant Secretary for Single Family Housing

- 1A. Direct the applicable lenders to provide evidence that the properties for the four FHA-insured loans reviewed, which had lead and copper levels above the EPA action level, had a safe and potable water source at the time the loans closed and were endorsed, or, if the lenders cannot provide this evidence, direct them to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD against any future loss, thereby putting up to \$215,571 to better use.

¹⁵ These 127 loans are part of the 144 loans that were endorsed after the health department first declared a public health emergency on October 1, 2015. As discussed in the Scope and Methodology section of this report, we reviewed 17 of the 144 loans. Based on the results of our review, we believe that the files for the additional 127 loans not reviewed may not contain evidence of water testing and the related properties may have high levels of lead and copper.

- 1B. Direct the applicable lenders to provide evidence that the properties for the seven additional FHA-insured loans reviewed, for which the files did not contain evidence of water testing, had a safe and potable water source at the time the loans closed and were endorsed, or, if the lenders cannot provide this evidence, direct them to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD against any future loss, thereby putting up to \$570,827 to better use.
- 1C. Direct the applicable lenders to provide evidence that the properties for the 99 FHA-insured loans, which closed after October 1, 2015, but were not included in our sample, had a safe and potable water source at the time the loans closed and were endorsed, or, if the lenders cannot provide this evidence, direct them to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD against any future loss, thereby putting up to \$7,514,800 to better use.
- 1D. Direct the applicable lenders to provide evidence that the properties for the 28 FHA-insured loans, which closed before October 1, 2015, and were endorsed after October 1, 2015, but were not included in our sample, had a safe and potable water source at the time the loans closed and were endorsed, or, if the lenders cannot provide this evidence, direct them to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD against any future loss, thereby putting up to \$2,512,464 to better use.
- 1E. Take appropriate administrative action against the lenders and appraisers for any cases (identified through recommendations 1A through 1D) where it finds that they did not take appropriate steps to ensure that properties had a safe and potable water source.
- 1F. Improve its controls to ensure that it does not insure additional loans in Flint for properties that do not have a safe and potable water source. These controls could include updating its endorsement or monitoring processes until the water contamination issue has been resolved in Flint.

Scope and Methodology

We conducted the audit from March through May 2016 at our offices located in Philadelphia and Pittsburgh, PA. The audit covered the period April 2014 through March 2016.

To achieve our audit objective, we reviewed

- Relevant background information;
- Applicable regulations, HUD handbooks, mortgagee letters, and other guidance;
- The Flint water crisis timeline of events and residential water testing data located on the State's Web site;¹⁶ and
- Complete loan files provided by the lenders.

We interviewed HUD staff from the Office of Single Family Housing and the Philadelphia Homeownership Center.

We relied in part on computer-processed data in HUD's Single Family Data Warehouse. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequate for our purposes. The testing included matching information obtained from the Single Family Data Warehouse to the complete loan files provided by the lenders.

To select a sample of loans for review, we obtained and analyzed data contained in HUD's Single Family Data Warehouse, along with residential water testing data from the State's Web site to determine whether HUD had insured loans on properties that had tested above the EPA's action level for lead or copper and to select a sample of loan files for review. The data from HUD's Single Family Data Warehouse was current as of March 10, 2016, and the State's water testing data was current as of March 25, 2016. We identified 616 FHA-insured loans that closed on or after April 25, 2014, with unpaid balances totaling \$45.8 million. Of the 616 loans,

- We identified 114 loans that closed after October 1, 2015, with unpaid balances totaling more than \$8.6 million. Of these 114 loans, the properties for 13 loans had testing results on the State's Web site as of March 25, 2016. Of the 13 properties, 2 had lead levels exceeding the EPA action level, and 1 had copper levels exceeding the EPA action level. The lenders that underwrote these 2 loans had a total of 15 loans in our universe of 114 loans. We selected all 15 of these loans for review because the high lead levels gave us reason to believe that the lenders had not ensured that the properties had a safe and potable water source, despite the loans closing after the public was informed by the government that the water was not safe.

¹⁶ The State established <http://www.michigan.gov/flintwater> as a central location for information related to the Flint water crisis.

- We identified 30 loans that closed before October 1, 2015, but were endorsed after October 1, 2015, with unpaid balances totaling \$2.6 million. Of these 30 loans, the properties for 4 loans had testing results on the State's Web site, 2 of which had lead levels exceeding the EPA action level. We selected the two loan files for review to determine whether HUD had ensured that loans closed on or before but endorsed after October 1, 2015, met requirements for a safe and potable water source before endorsement.

In total, our sample included 17 loans, with unpaid balances totaling \$11.2 million, from 4 different lenders. Although this approach did not allow us to make a projection to the entire population of FHA-insured properties in Flint since April 25, 2014, with unpaid balances totaling \$45.8 million, it was sufficient to achieve our objective. For each of the 17 loans in our sample, we obtained and reviewed complete loan files to identify information related to the water source, water quality, testing performed on the water, and remediation related to water quality issues.

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(s). 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 control was relevant to our audit objective:

- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that the use of resources is consistent with laws and regulations.

We assessed the relevant control 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 Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- HUD lacked adequate controls to ensure that lenders complied with all applicable requirements when approving loans for properties located in Flint, and that FHA-insured properties in Flint had a continuing and sufficient supply of safe and potable water.

Appendixes

Appendix A

Schedule of Funds To Be Put to Better Use

Recommendation number	Funds to be put to better use 1/
1A	\$215,571
1B	570,827
1C	7,514,800
1D	2,512,464
Total	\$10,813,662


- 1/ 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, implementation of our recommendations to direct the applicable lenders to provide evidence that the properties had a safe and potable water source at the time the loans closed and were endorsed, or, if the lenders cannot provide this evidence, direct them to perform water testing and any necessary remediation to ensure that the properties have a safe and potable water source, or indemnify HUD would reduce the risk of loss to the FHA insurance fund because HUD would be relieved of potential future claim liabilities for any properties shown not to have a safe and potable water source.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments



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

OFFICE OF HOUSING

JUL 08 2016

MEMORANDUM FOR: David E. Kasperowicz, Regional Inspector General for Audit,
Philadelphia Region, 3AGA

FROM: Robert E. Mulderig, Acting Deputy Assistant Secretary for Single
Family Housing, HU *RE Mulderig*

SUBJECT: Discussion and Comments on Draft Audit:
HUD Did Not Ensure That Mortgagees Verified That Properties with FHA-
Insured Mortgages in Flint, MI Had Safe Water

OIG Audit Report 2016-PH-XXXX
Issue Date: July, 2016

The Office of Inspector General (OIG) performed the subject audit of the U.S. Department of Housing and Urban Development's (HUD) oversight of Federal Housing Administration (FHA) - insured loans in Flint, MI. The objective of the audit was to determine whether HUD ensured that mortgagees verified that properties in Flint, MI with FHA mortgage insurance had a continuing and sufficient supply of safe and potable water. The OIG reviewed the loans files for 17 properties with FHA-insured mortgages that were endorsed after October 1, 2015. The OIG found that the loan files for six of these properties contained evidence of water testing and showed that the property had access to safe and potable water. In 11 of the files, OIG reports found that there was no evidence of water testing to show that the water was safe. In four of these 11 files, water testing conducted by the State of Michigan subsequent to loan closing and endorsement showed that the properties had lead content above the action levels specified by the Environmental Protection Agency (EPA).

FHA guidelines evidence the program's commitment to ensuring that residences that are candidates for mortgage insurance have a safe and potable water supply. FHA's long-standing regulations at 24 CFR § 200.926d set minimum property requirements for FHA mortgage insurance that include, among other criteria, that the home "shall be provided with a continuing and sufficient supply of safe water under adequate pressure and appropriate quality for all household uses."

FHA generally agrees with OIG's recommendations and has been working to ensure that its mortgagees and appraisers in the Flint, MI area are meeting their obligations under applicable regulations.

On February 8, 2016, FHA issued its "FHA Information on Water Contamination Crisis in Flint, Michigan." The FHA Info and accompanying fact sheet reminded mortgagees and other

www.hud.gov espanol.hud.gov

Comment 1

Comment 2

Comment 3

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 3

stakeholders involved with FHA transactions that properties with FHA-insured mortgages “must meet FHA’s Property Acceptability Criteria”; and FHA has initiated a review of loan files for insured mortgage loans for which appraisals were completed after that date in order to assess compliance with program guidance related to minimum property requirements. (This work supplements HUD’s continued efforts in response to the Flint water crisis, including: extending the Strong Cities/Strong Communities engagement in Flint through 2016 to help increase capacity for long-term economic development in the region; reserving funds for the Flint Housing Commission to assist public housing and housing choice voucher residents; providing technical assistance to the City of Flint on how best to leverage existing HUD resources to respond to this crisis; and coordinating the economic recovery work of the federal interagency working group.)

FHA Response to OIG Proposed Findings and Recommendations

In general, FHA agrees with most of the conclusions that have been identified in OIG’s report. FHA also believes that the draft report does not fully take into account the four key issues relevant to FHA policy and procedures:

1. Timeframes Matter

Comment 4

FHA believes that mortgage loans endorsed for FHA insurance during the period October 1, 2015 through January 16, 2016—and the information provided in those loan files by appraisers and lenders regarding the water supply for the subject housing unit—should be considered individually, relative to the changing landscape of circumstances and information provided by State and local authorities about the condition of publicly sourced water in Flint.

Specifically, on October 1, 2015, the Genesee County Board of Commissioners warned residents regarding safety concerns with the Flint City water supply. That announcement recommended that people not drink City of Flint water having the Flint River as its source, unless there was clear evidence of the water’s safety through testing or filtration systems. Despite this declaration, local officials continued to make public announcements that they would ensure that Flint residents would have access to safe and potable water.

On October 16, 2015, the water supply for the City of Flint was switched from the Flint River and reconnected to the Detroit Water and Sewage Department, which supply was considered safe relative to lead contamination. Following the reconnection, on December 9, 2015, the City of Flint began to add additional corrosion controls to its water piping system. On December 14, 2015, the City of Flint Mayor declared a state of emergency, noting that the “lead levels remain well above the federal action level of 15 parts per billion in many homes.” On January 5, 2016, the Governor declared a state of emergency in Genesee County due to the condition of the water supply. The announcement noted that, despite assurances to the contrary, “local resources have been insufficient to address the situation, and additional assistance from voluntary organizations and the state is required to protect public health, safety, and property, and to lessen or avert the threat of more severe and long lasting impacts to the community.”

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Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 5

On January 16, 2016, President Obama issued a declaration that “an emergency exists in the State of Michigan [requiring] federal aid to supplement state and local response efforts due to the emergency conditions in the area affected by contaminated water.”

2. Impact of FHA Advisory and Follow-up

Following the Presidential Declaration, FHA issued on February 8, 2016, its “FHA Information on Water Contamination Crisis in Flint, Michigan.” The FHA Info and accompanying fact sheet reminded mortgagees and other stakeholders involved with FHA transactions of existing requirements relative to water quality—that properties with FHA-insured mortgages “must meet FHA’s Property Acceptability Criteria” and that, given the water crisis in Flint, mortgagees may require evidence that the property meets water safety requirements “such as testing or remediation.”

Comment 6

FHA records evidence that, through June 24, 2016, mortgage loans for 50 housing units in Flint, MI, with appraisals completed on or after February 8, 2016, have been endorsed for FHA insurance. FHA is currently in the process of retrieving and reviewing those mortgage loan files to determine whether there is evidence that properties with water supplied from a public water source had access to potable water. While our research is not complete, to date we have found no loan file which demonstrates that the residence’s water supply has been documented to be unsafe. We are optimistic that as a result of FHA’s efforts, water safety testing is now occurring in Flint in any situation in which a mortgage loan proposed for FHA insurance is for a residence having a questionable water supply. Furthermore, we believe that increased water testing is now routinely resulting in mortgage loans not being submitted for endorsement when the tests reveal unsafe water.

Comment 7

3. Access to Credit

Concurrent with FHA’s duty to enforce the standards for minimum property requirements for homes that are candidates for FHA insurance is FHA’s commitment to carry out the Secretary’s goal of promoting access to credit in all communities. This commitment is particularly important in communities like Flint that are underserved by the mortgage lending community. While it is critical that FHA enforce requirements for a safe and healthy housing stock, it is also critical that FHA not eliminate opportunities for access to credit for families who most need it for home purchase. The February 2016 FHA Info and fact sheet addressed how FHA-approved mortgagees and appraisers can fulfill their obligation to ensure that properties have access to potable water and to continue lending in the region during the water crisis. The announcement also served to allay any concerns of Flint residents, elected officials, and other stakeholders that a perceived inability to lend in Flint would devastate the housing market.

Comment 8

4. National Policy

It is essential that FHA’s policy for underwriting mortgage loans is consistent across the entire nation—including, but not limited to, the requirement for a safe and potable water supply. When a mortgage is submitted for endorsement, FHA requires a property appraisal as well as an underwriter certification stating that the underwriter personally reviewed the appraisal report and credit application and that the proposed mortgage complies with FHA underwriting requirements, including FHA’s requirement for a safe and potable water. The appraiser must be an FHA Roster

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Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 8

appraiser, licensed and geographically competent. Geographic competency means that the appraiser is familiar with the local area and understands the local market. Relative to water quality, the requirement for local competency puts the burden on each appraiser to know whether water testing is necessary. It would be impractical—and unwise—for FHA to have locality-by-locality variations in national policy for FHA eligibility. FHA is committed to ensuring that FHA-insured properties in all communities have access to safe and potable water, as well as that consistent guidance for lenders and appraisers is applied, especially in relationship to prevailing health hazards.

Conclusion

Throughout this period, FHA has taken the situation in Flint seriously, and we will continue to monitor the application of our existing policies relative to the quality of water supplied to homes in Flint for which mortgage loans are insured by FHA. At the same time, FHA is also mindful that its program and guidelines have a national reach, designed to ensure that they can be applied in uniform manner across the nation, and that they continue to provide opportunities for access to credit for potential homebuyers who most need it. We believe that FHA's review of appraiser and mortgagee compliance—in particular, our review and analysis of the actions taken by appraisers and mortgagees in the aftermath of the Flint water crisis—positions FHA to be more responsive to similar situations in the future.

FHA appreciates OIG's diligent study in this matter, and we look forward to a continued dialogue regarding how FHA can best apply its existing underwriting policies relative to minimum property standards, to ensure that new homebuyers are able to purchase safe and healthy homes. Thank you for the opportunity to comment on your draft audit report; I hope these comments are helpful as you prepare your final report.

OIG Evaluation of Auditee Comments

- Comment 1 HUD stated that FHA guidelines evidence the program’s commitment to ensuring that residences that are candidates for mortgage insurance have a safe and potable water supply and cited regulations at 24 CFR 200.926d. While it is important that HUD has these regulations, we found that HUD did not have adequate controls in place to ensure that lenders verified that properties in Flint, MI, that were approved for FHA mortgage insurance after the first emergency declaration was made on October 1, 2015, had a continuing and sufficient supply of safe and potable water.
- Comment 2 HUD indicated that it generally agrees with OIG’s recommendations and has been working to ensure that its lenders and appraisers in the Flint, MI, area meet their obligations under applicable regulations. As part of the audit resolution process, HUD will need to detail the actions it plans to take to address each recommendation.
- Comment 3 HUD indicated that its February 8, 2016, issuance and the work it has initiated in response to our audit supplement its continued efforts in response to the Flint water crisis. These efforts include extending the Strong Cities, Strong Communities engagement in Flint through 2016, reserving funds for the Flint Housing Commission to assist public housing and Housing Choice Voucher program residents, providing technical assistance to the City on how best to leverage existing HUD resources to respond to this crisis, and coordinating the economic recovery work of the Federal interagency working group. We acknowledge that HUD has taken several positive steps toward addressing the Flint water crisis. For example, according to a May 2016 fact sheet released by the White House about Federal support for the Flint water crisis response and recovery, HUD has worked with the Flint Housing Commission to ensure installation and future upkeep of water filters in every unit of public housing. However, we found that since the first public health emergency declaration was made on October 1, 2015, HUD’s efforts were not adequate to ensure that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water.
- Comment 4 HUD contended that loans endorsed for FHA insurance during the period October 1, 2015, through January 16, 2016, – and the information provided in those loan files by appraisers and lenders regarding the water supply for the subject housing unit – should be considered individually, relative to the changing landscape of circumstances and information provided by State and local authorities about the condition of publicly sourced water in Flint. HUD further stated that despite the Genesee County Board of Commissioners’ public health emergency declaration on October 1, 2015, local officials continued to make public announcements that they would ensure that Flint residents would have access to safe and potable water. We disagree with HUD regarding how it plans

to consider loans that were endorsed during the period October 1, 2015, through January 16, 2016, on a case-by-case basis. While the presidential declaration of emergency did not take place until January 16, 2016, the timing of this declaration did not change the responsibility of lenders to ensure that properties in Flint, MI, had a continuing and sufficient supply of safe and potable water. The Genesee County Health Department declared a public health emergency and issued a “do not drink” advisory on October 1, 2015. Between October 1, 2015, and January 16, 2016, the public health emergency and “do not drink” advisory were still in effect. Therefore, lenders should have verified that properties in Flint, MI, had a continuing and sufficient supply of safe and potable water through water testing before loans were approved for FHA mortgage insurance. Further, we note that additional emergency declarations were made during the period in question, including declarations by the City on December 14, 2015, the Genesee County Commission on January 4, 2016, and the State of Michigan on January 5, 2016.

- Comment 5 HUD indicated that it issued its “FHA Information of Water Contamination Crisis in Flint, Michigan” document on February 8, 2016, following the presidential declaration. HUD stated that this document reminded lenders and other stakeholders involved with FHA transactions of the requirements for properties to be eligible for insurance and said that given the water crisis in Flint, lenders may require evidence that properties meet water safety requirements, such as testing or remediation. We found that while the document did state that lenders may require evidence, this statement was in response to a general question about what evidence is required. In response to a question asking whether there were policies requiring water testing on properties in Flint, MI, the document stated that a water test is required for properties located in areas serviced by public water systems with unacceptable levels of contaminants.
- Comment 6 HUD indicated that it is in the process of reviewing loan files for 50 properties located in Flint, MI, for which the appraisals were completed on or after February 8, 2016. HUD further stated that while its research is not complete, it has not identified any loan files in which the water supply was documented to be unsafe. It believed that as a result of its efforts, water testing is now occurring. However, as HUD indicated during a June 28, 2016, meeting, several of the 50 loan files that it was reviewing did not contain evidence of water testing, similar to the 11 loan files discussed in the finding that did not contain evidence of water testing to show that the water was safe. Without evidence of water testing, HUD cannot ensure that lenders verified that properties in Flint, MI, that were approved for FHA mortgage insurance had a continuing and sufficient supply of safe and potable water. Further, while reviewing loans for which the appraisals were completed on or after February 8, 2016, is a positive step toward addressing our recommendations, HUD needs to review the loan files for all loans that were endorsed after October 1, 2015.

Comment 7 HUD indicated that concurrent with its duty to enforce the standards for minimum property requirements is FHA's commitment to carry out the Secretary's goal of promoting access to credit in all communities and noted that this is particularly important in communities like Flint that are underserved by the mortgage lending community. HUD stated that it is critical that FHA not eliminate opportunities for access to credit for families who most need it for home purchase. Although HUD's commitment to carry out the Secretary's goal of promoting access to credit in all communities is important, the ongoing safety concern for homeowners and household members should be a priority. As discussed in the finding, we found that HUD insured at least four properties in Flint, MI, that had lead and copper levels above the EPA action level. According to the EPA, exposure to lead in drinking water may cause cardiovascular issues, increased blood pressure, decreased kidney function, and reproductive problems in adults. Infants and children are at risk of behavior and learning problems, lower IQ's, hyperactivity, slowed growth, hearing problems, and anemia. Further, both the EPA and the Centers for Disease Control and Prevention agree that there is no known safe level of lead in a child's blood. Exposure to copper in drinking water may cause gastrointestinal distress as well as liver or kidney damage.

Comment 8 HUD indicated that it is essential that FHA's policy for underwriting mortgage loans be consistent across the entire Nation – including but not limited to the requirement for a safe and potable water supply. It noted that when a mortgage is submitted for endorsement, FHA requires a property appraisal and an underwriter certification, stating that the underwriter personally reviewed the appraisal report and credit application and that the proposed mortgage complies with FHA underwriting requirements, including FHA's requirement for a safe and potable water supply. HUD further stated that appraisers must be geographically competent, which means that the appraiser is familiar with the local area and understands the local market. Relative to water quality, HUD indicated that the requirement for local competency puts the burden on each appraiser to know whether water testing is necessary. Based on the results of our audit, we do not believe that lenders and underwriters met their responsibility to ensure that properties in Flint, MI, had a safe and potable water supply and that appraisers had a consistent understanding of when water testing was necessary. For example, we found evidence of water testing for five loans for which the appraisals were completed after the Genesee County Health Department declared a public health emergency and issued a "do not drink" advisory on October 1, 2015, and for one loan for which the appraisal was completed before October 1, 2015. In contrast, we identified 11 loans for which the files did not contain evidence of water testing, including 7 loans for which the appraisals were completed after various declarations. In one case, the appraisal was completed on January 13, 2016, and the loan file did not contain evidence of water testing. This appraisal was completed after the October 1, 2015, declaration discussed above and after additional emergency declarations were made by the City on

December 14, 2015, the Genesee County Commission on January 4, 2016, and the State of Michigan on January 5, 2016. HUD should take appropriate administrative action against the lenders and appraisers for any cases in which it finds that they did not take appropriate steps to ensure that properties in Flint, MI, had a safe and potable water source and improve its controls to ensure that it does not insure additional loans in Flint for properties that do not have a safe and potable water source.